Federal Tax Update (PowerPoint)

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THE NEW STAKES

- Current Rate on Long Term Capital Gain (“LTCG”) = 20% (plus state)
- Current Rate on Ordinary Income = 37% (with possible reduction to 29.6%) (plus state)
- Special 25% rate (plus state) on Section 1250 Gain
- Special 28% rate (plus state) on art and collectibles
- AMT Trap (28%) is not repealed but with SALT deductions limited, unlikely to apply in many situations
- Capital Losses – Netting Process
- Ordinary Losses
- Note: State and local tax laws may not offer any preference for LTCG. Note Florida, Texas and Nevada residents (among others) have no state or local income tax but other states may tax these nonresidents.
“Unearned Income Medicare Contribution Tax” on “investment income” – 3.8% of lesser of net investment income or excess of AGI over $250,000 (for married individuals). Investment income includes rents and gains from sales unless attributable to ordinary course of trade or business – Income from a passive activity trade or business is not counted as a trade or business.

States will have tax structures that “decouple” from federal law.

A big challenge will be finding ways to minimize damage from SALT limitations.
TCJA provides a deduction to individuals, estates and trusts up to 20% of “Qualified Business Income” (“QBI”). The purpose is to narrow the gap between the tax rate applicable to C corporations (21%) and non-C corporations (37%).

Section 199A deduction is taken after itemized deductions.

The deduction does not reduce self employment tax or Section 1411 Obama Tax (3.8%).

Individuals, estates and trusts may receive QBI directly or through “relevant passthrough entities” (“RPE”). RPE is a partnership (other than a PTP) or an S corporation. A trust or estate is an RPE to the extent it passes through QBI, W-2 wages, unadjusted basis of qualified property, qualified REIT dividends or qualified PTP income. Prop. Reg. §1.199A-1(b)(9).

Deduction cannot exceed the lesser of (i) 20% of QBI or (ii) the greater of:

- 50% of taxpayer’s share of W-2 wages allocable to a qualified business, or
- 25% of taxpayer’s share of W-2 wages allocable to a qualified business, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property.

QBI DEFINED

- QBI = Net amount of qualified items of income, gain, deduction and loss with respect to a qualified trade or business of the taxpayer.

  - With respect to a partnership, hot asset gain under Section 751(a) and (b) is allocable to the partnership’s trade or business and is included in QBI. Prop. Reg. §1.199A-3(b)(1)(i).

  - Disallowed losses by virtue of Sections 465, 469 or 704(d) are taken into account in computing QBI when allowed unless these losses were first disallowed in a taxable year ending before January 1, 2018. Prop. Reg. §1.199A-3(b)(1)(iv).

  - NOLs are not taken into account in computing QBI except where disallowed as an excess business loss under Section 461(l). Prop. Reg. §1.199A-3(b)(1)(v).

  - Guaranteed payments for services or for the use of capital are not QBI to the recipient (although they are deductible, thereby reducing QBI of the partnership). Prop. Reg. §1.199A-3(b)(1)(ii) and -3(b)(2)(ii)(L).

  - Payments received by a partner for services under Section 707(a) are not QBI. Prop. Reg. §1.199A-3(b)(2)(ii)(J). This also reduces the partnership’s QBI.

  - Reasonable compensation received by a shareholder from an S corporation is not QBI but does reduce QBI. Prop. Reg. §1.199A-3(b)(2)(ii)(H).
QBI does not include certain tax items in the nature of investment income/loss. Prop. Reg. §1.199A-3(b)(2)(ii).

- Capital gain or loss (short term or long term)
- Gains and losses under Section 1231 which are treated as capital gains or losses. What about 1231 gain that is recaptured as ordinary income because of 1231 losses in last five years? What about 1231 losses treated as ordinary deduction?
- Interest income other than interest income properly allocable to a trade or business. Interest income attributable to working capital, reserves, etc. is not properly attributable to a trade or business….
**QBI = FROM A “TRADE OR BUSINESS”**

- Trade or business is defined by reference to Section 162 except an employee cannot be in a trade or business. Prop. Reg. §1.199A-1(b)(13).

- Is a triple net lease property a trade or business? Note that Prop. Reg. §1.199A-4(b)(1) provides that a rental of property will be a Section 162 trade or business if the property is rented to a trade or business under common control.

- Each trade or business of a taxpayer is a separate trade or business for purposes of Section 199A except to the extent they can be aggregated under the regs. Aggregation, once made, generally cannot be changed. Under Prop. Reg. §1.199A-4, to aggregate, taxpayer must show:
  1. Same person or group of persons directly or indirectly owns 50% or more of each trade or business. Family attribution applies. For partnerships, 50% or more of capital or profits.
  2. Generally must have same taxable year.
  3. None is specified service trade or business.
  4. At least two of the following must be satisfied:
     - The trades or businesses provide products or services that are the same or customarily offered together;
     - The trades or businesses share facilities or significant centralized business elements (e.g., personal, accounting, legal, HR, IT, etc.)
     - The trades or businesses are operated in coordination with or reliance upon one or more other businesses in the group.
MEASURING W-2 WAGES

- Identifying W-2 wages attributable to a qualified trade or business could be an easy exercise or perhaps not so easy.
  - Notice 2018-64 provides methods for calculating W-2 wages.
  - Payments to independent contractors do not count.
  - Partnership guaranteed payments for services do not count.

- Payments of W-2 wages by a third party may be taken into account if the W-2 wages were in fact paid to common law employees or officers of the taxpayer or RPE for employment by the taxpayer or RPE. Prop. Reg. §1.199A-2(b)(2). This should cover employee leasing, common payments, etc.

- If W-2 wages of an individual are allocable to more than one trade or business, allocation must be pursuant to reasonable method based upon all facts and circumstances.

- What if a management company employs all employees and the management company manages properties owned by affiliates under a management agreement?
UNADJUSTED BASIS OF QUALIFIED PROPERTY

- The 2.5% of “Unadjusted Basis” of “Qualified Property” benefits capital intensive businesses including real estate.

- “Qualified Property” is:
  1. Tangible property;
  2. Depreciable (not inventory, dealer property, land, etc.);
  3. Used at any point during the taxable year in production of QBI;
  4. Held by and available for use in the qualified trade or business at close of taxable year (See Prop. Reg. §1.199A-2(c)(1)(iv) for anti-abuse rule);
  5. The “depreciable period” for the property has not ended before close of the taxpayer’s (or REP’s) taxable year. This is the period beginning on the date first placed in service by the taxpayer or RPE and ending on the later of (i) 10 years after first placed in service or (ii) last day of the last full year in applicable recovery period under Section 168. Prop. Reg. §1.199A-2(c)(2).

- Basis adjustments under Sections 734(b) and 743(b) are not qualified property. Prop. Reg. §1.199A-2(c)(1)(iii).
In the case of a 1031 exchange, there are special rules.

- For purposes of the “depreciable period” requirement, the exchanged basis portion of replacement property is treated as first placed in service on the date the relinquished property was first placed in service; the excess basis portion is treated as acquired when the replacement property is first placed in service. See special election per Reg. §1.168-6(i)(1). Prop. Reg. §1.199A-2(c)(2)(iii).

- For purposes of measuring the unadjusted basis, a nonrecognition transaction such as 1031 exchange, 721 contribution and 731 distribution, the unadjusted basis resets to the adjusted basis as of the new placed in service date.
Prop. Reg. §1.199A-1(d)(2)(iii)(A) provides that if, after aggregating all trades or businesses that are permitted to be aggregated, a taxpayer’s QBI from one or more trades or businesses is negative (i.e., a loss), the taxpayer must allocate the QBI loss among the trades or business that produced positive QBI (in proportion to such positive QBI).

If the taxpayer’s QBI from all trades or business combined is negative, the QBI is zero. The negative QBI is carried over and treated as negative QBI from a separate trade or business in the next taxable year.

- This rule does not affect the deductibility of the loss under other provisions of the Code.
- The W-2 wages and unadjusted basis of qualified property from the trades or businesses that produced the loss are not carried over.
**SPECIAL RULES**

- **Under Threshold Taxpayers.** Where taxpayers have taxable income that does not exceed $157,500 ($315,000 in the case of joint returns), the W-2 wages and unadjusted basis limitations do not apply and the taxpayer gets a full 20% of QBI deduction but not greater than 20% of the taxable income in excess of net capital gain. This rule also applies to specified service trades or businesses.
  
  - The threshold benefits are phased out over the next $50,000 of taxable income ($100,000 for joint return).
  
  - The threshold amount is increased by cost of living adjustments.

- **REITs/PTPs.** Qualified REIT dividends (except the portion eligible for capital gains or qualified divided income) is eligible for automatic 20% deduction without regard to the limitations. Same with Qualified PTP income.

- **Specified service trades or businesses.** These are not eligible for the 20% deduction. The Proposed Regs have taken a very onerous approach with respect to required aggregation of activities that may otherwise constitute qualified trades or businesses.
TCJA imposes yet another limitation on the ability to deduct losses. This is significant for real estate professionals who are not subject to PAL limitations.

- Basis
- At risk
- PAL

Section 461(l) – “Excess Business Losses” are not deductible currently but are carried forward as part of taxpayers’ NOLs.

- Excess Business Losses that are carried over are not counted as Excess Business Losses in the future year.
- Excess Business Losses become part of NOL subject to 80% of taxable income limitation.

For married filing jointly, $500,000 of losses can be deducted currently: Business income and gain plus $500,000 less all trade or business deductions—cannot be less than zero.

- In other words, a real estate professional with a salary of $1 million and aggregate net losses of $800,000 can only shelter $500,000 of the salary and the remaining $300,000 is part of NOL carryover.
- This rule could apply to passive investors where, for example, suspended losses are freed up on disposition of a passive activity.

For partnerships and S corporations, this rule is applied at the partner/stockholder level.
EXCESS BUSINESS LOSS LIMITATION (CONT’D)

- NOLs can now be carried forward indefinitely but cannot be carried back.
- NOLs that are carried forward are limited to 80% of taxable income (without regard to the NOL).
- Note: Taxpayers may not want to accelerate deductions if the result is net losses that are Excess Business Losses because of the 20% “haircut” on NOLs.
NEW INTEREST DEDUCTION LIMITATIONS

- TCJA amends Section 163(j) to substantially limit the deduction for interest allocable to a trade or business. The deduction is limited to the sum of business interest income plus 30% of “adjusted taxable income.”

- Until 2022, Adjusted Taxable Income is taxable income without regard to items not allocable to a trade or business, business interest income and deductions, depreciation amortization and depletion, the 20% QBI deduction and NOLs.

- After 2021, Adjusted Taxable Income is more onerous by requiring the inclusion of depreciation, amortization and depletion.

- Section 163(j) applies after other rules such as Section 263A (capitalization of interest) and after interest disallowance rules (e.g., Section 265 and 279).

- Disallowed interest expense can be carried forward indefinitely.

- Interest on debt existing before 2018 is not grandfathered.
SMALL BUSINESS EXCEPTION

- Section 163(j) does not apply to a taxpayer (including an individual, corporation, or partnership) if the average annual gross receipts of such taxpayer for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed $25,000,000.

  ➢ The gross receipts of two or more corporations or partnerships are aggregated in computing the average if the corporations or partnerships are treated as one employer under Section 52(a), 52(b), 414(m), or 414(o).

  ➢ Unclear of how the exception applies for the first year of an entity’s existence. Arguably, the average of gross receipts for the three years preceding this year is zero.
A “tax shelter” (as defined in Section 448(d)(3)) does not qualify for the exception. Generally, a tax shelter is any of:

- An entity (other than a C corporation) if interests in the entity have been offered for sale in an offering required to be registered under state or federal securities laws.

- A partnership, S corporation, or other pass-through entity if more than 35% of its losses for the taxable year are allocable to limited partners or to shareholders or other owners who do not participate actively in the entity’s management.

- A partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, if a significant purpose of such partnership, entity, plan or arrangement is the avoidance or evasion of Federal income tax.
The following are excluded from a “trade or business” for purposes of Section 163(j):

- the trade or business of performing services as an employee,
- any electing real property trade or business,
- any electing farming business, or
- the trade or business of the furnishing or sale of (a “Utility Business”):
  - electrical energy, water, or sewage disposal services,
  - gas or steam through a local distribution system, or
  - transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.
ELECTING REAL PROPERTY TRADE OR BUSINESS

- An “electing real property trade or business” is any trade or business described in Section 469(c)(7)(C) and which makes an election under Section 163(j)(7)(C).
  - Any such election, once made, is irrevocable.
  - Need to be careful before making election—prior to 2022 “Adjusted Taxable Income” ignores depreciation and amortization.

- A trade or business described in Section 469(c)(7)(C) is any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

- Unclear whether an election for one of the trades or businesses described in Section 469(c)(7)(C) will automatically cause the election to apply to all other trades or businesses described in such election that are carried on by the taxpayer.
Making the election causes nonresidential real property, residential rental property, and qualified improvement property held by the electing real property trade or businesses to be depreciated under the alternative depreciation system.

Longer recovery period:

- Nonresidential real property: from 39 years to 40 years.
- Residential real property: from 27.5 years to 30 years. Issue whether pre-2018 property is 40 years based on pre-TCJA ADS rules.
- Qualified improvement property: from 15 years to 20 years.

Qualified improvement property loss of bonus and accelerated depreciation (must use straight line).
MULTIPLE TRADES OR BUSINESSES

- Unclear how an entity (including a consolidated group) that has multiple trades or businesses would apply the limitation to each activity.

- For example, if a corporation is engaged in each of the following businesses (either through affiliates or disregarded entities):
  
  - A financing business (has high business interest income from such business);
  
  - An electing real property trade or business (Section 163(j) does not apply to such business); and
  
  - A manufacturing business (regular rules under Section 163(j) apply to such business).
“Adjusted taxable income” means the taxable income, computed without regard to:

- income, gain, deduction, or loss which is not properly allocable to a trade or business,
- business interest expense or business interest income,
- any net operating loss deduction under section 172,
- any deduction allowed under section 199A, and
- in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.
In the case of a partnership, the limitation on business interest expense is determined at the partnership level, and any business interest expense deduction is taken into account in determining the partnership’s non-separately stated taxable income or loss for a given taxable year of the partnership.

Limitation will equal the sum of:

1. the partnership’s “business interest income” for the taxable year;
2. 30% of the partnership’s “adjusted taxable income” for the taxable year; and
3. the partnership’s “floor plan financing interest” for the taxable year.
A partnership’s disallowed business interest expense is not treated as business interest expense paid by the partnership in the succeeding taxable year.

Instead, a partnership’s disallowed business interest expense is treated as “excess business interest” allocated to its partners and treated as paid or accrued by the partner to whom allocated in the next succeeding year but only to the extent of the partner’s distributive share of the partnership’s “excess taxable income.”

Thus, the partners will have to track their share of the partnership’s:

- “Excess business interest” and
- “Excess taxable income.”

Any “excess business interest” that is treated as paid or accrued by the partner is carried forward to the next succeeding years until the partner’s “excess business interest” is eliminated.
A partnership’s “excess taxable income” is generally:

a. the amount which bears the same ratio to the partnership’s adjusted taxable income as the excess of (i) 30% of the partnership’s adjusted taxable income, over (ii) the amount (if any) by which the partnership’s business interest expense exceeds its business interest income bears to

b. 30% percent of the partnership’s adjusted taxable income.

Any unused “excess taxable income” does not carry forward.

A partner may use any unused excess taxable income in calculating its Section 163(j) limitation for interest expense paid on indebtedness from other sources.

IRS Notice 2018-28 clarified that a partner can include the partner’s share of partnership business interest income for the taxable year to the extent it exceeds the partner’s share of such partner’s partnership business interest expense.
If the limitation under Section 163(j) applies to a partnership, each partner decreases its adjusted tax basis (not below zero) in its partnership interest by its distributive share of the partnership’s disallowed business interest expense.

If a partner disposes of a partnership interest (including where gain is not recognized), the partner’s adjusted basis in the partnership interest is increased immediately before the disposition by the amount of the excess (if any) of:

i. the amount of the partner’s basis reduction attributable to the partnership’s disallowed business interest expense over

ii. The portion of any excess business interest allocated to the partner which was previously treated as business interest paid or accrued by the partner (i.e. because of excess taxable income).

The rule above allows a partner to restore its adjusted basis for excess business interest that was not deducted in future years.
APPLICATION TO PARTNERSHIPS - EXAMPLE

- Year 1:
  - AB Partnership has the following items of income:
    - Adjusted taxable income: $30
    - Interest expense: $35
    - No interest income or floor plan financing interest.
  - Section 163(j) limitation applies in year 1 because the partnership’s interest expense ($35) exceeds 30% of its adjusted taxable income ($9). Thus, only $9 of business interest expense is taken into account in determining AB partnership’s non-separately stated taxable income or loss.
  - The excess ($26) is treated as excess business interest allocated equally to A and B ($13 each).

- Year 2:
  - AB Partnership has the following items of income:
    - Adjusted taxable income: $150
    - Interest expense: $35
    - No interest income or floor plan financing interest.
  - Section 163(j) limitation does not apply because the partnership’s interest expense ($35) does not exceed 30% of its adjusted taxable income ($45).
  - AB Partnership has of $33.33 of excess taxable income for year 2 ($150 x [($45 – ($35-0))/$45]). Partners A and B are allocated the $33.33 equally ($16.66 each).
  - Partner A and B’s excess business interest expense from year 1 is treated as paid in year 2 because their share of excess taxable income from year 2 exceeds the excess business interest from year 1.
  - Unused excess taxable income from year 2 does not carry forward.
NET INVESTMENT INCOME TAX AND TRUSTS: FRANK ARAGONA TRUST

- 3.8% NIIT applies to income and gain from passive activities. See Section 469.

- Example: Father and Mother own an LLC equally. The LLC owns a hotel that generates income. Father and Mother are actively involved in the management and operation of the hotel. The income is not passive under Section 469.

- Example: Father forms a grantor trust and transfers his 50% LLC interest to this trust. The trust has Daughter as its sole beneficiary. The trustee of the trust is Trusted Friend, an individual not involved in the hotel operations. Because the trust is a grantor trust, Father remains the taxpayer for income tax purposes and for NIIT purposes. NIIT is not applicable to the income of LLC flowing through the grantor trust.

- Example: Same facts except the trust is not a grantor trust. Frank Aragona Trust, 142 T.C. No. 9 (2014) provides guidance in the Section 469 context.
  - Trust owned various real estate investments. Can the Trust deduct losses by qualifying as a “real estate professional”?
    - More than half of personal services performed in trades or businesses by the taxpayer are where the taxpayer “materially participates.”
• Taxpayer performs more than 750 hours of service in the trades or business where the taxpayer materially participates.

➢ Tax Court concludes that a trust can qualify as a real estate professional. If trustees are individuals, their work as part of their trustee duties can qualify.

▪ Key in Frank Aragona Trust is that a non-grantor trust can avoid passive income and NIIT through the material participation and services of the trustees.
Executive Order 13789. On October 4, 2017 Treasury announced withdrawal of two sets of proposed regulations and outlined possible future actions.

➤ Proposed Estate Tax Valuation Regs (2704) are Withdrawn

Future Action Includes:

➤ Partial Revocation of Debt/Equity Regs (385)
➤ Partial Revocation of Partnership Debt Allocation and Disguised Sale Regs (707; 752)

Note: New Bottom Dollar Guaranty Rules will be retained.
FIGHTING DOCTORS AND SUBCHAPTER S

- Ramesh Kumar, T. C. Mem. 2013-184: Taxpayer and another doctor formed an S corporation for their practice. Taxpayer owned 40% of stock. In 2003, the doctors started fighting and the taxpayer was excluded from the operations and management of the S corporation. The dispute was not resolved until 2012 when the taxpayer sold his stock to the other doctor.

- In 2005, the taxpayer received a K-1 from the S corporation showing $215,000 of ordinary income. The S corporation had not made any distributions. Taxpayer did not report the K-1 income on his return, arguing that he had been excluded from the practice and was not a stockholder for tax purposes.

- Tax Court rejects taxpayer’s position. Taxpayer liable for unpaid tax, interest and penalties.

- Doctors and dentists usually lose tax cases! See also Alexander v. Com’r, T.C. Mem. 2013-203.

- Syed v. Com’r, T.C. Mem. 2017-226 – full-time practicing doctor claimed to be real estate professional under Section 469. Doctor loses; penalties imposed.
Section 1060(a): When parties to an asset acquisition agree in writing to an allocation of purchase price among the assets, the agreement is binding unless the Commissioner determines otherwise (or the agreement is unenforceable due to fraud, mistake, undue influence, etc.)

In Peco Foods, Inc., T.C. Mem. 2012-18 (affirmed by 11th Circuit in July 2, 2013 unpublished opinion), the taxpayer purchased assets from two unrelated sellers. In both purchase agreements there were detailed allocations among the assets. Both agreements provided that the allocations were “for all purposes (including financial accounting and tax purposes).”

In its tax returns immediately following the acquisitions, Peco depreciated the acquired assets consistently with the purchase agreements. For real property, Peco did not use any “cost segregation.”
Subsequently, Peco commissioned a “cost seg study” of the purchased real property. The study subdivided the real estate into various subcomponents and, according to the valuation experts, entitled Peco to additional depreciation deductions going forward.

Peco began using the new depreciation schedules for 1998, attaching to its return Form 3115 (Application for Change in Accounting Method). Peco reclassified certain 1250 property to 1245 property and changed from straight line over 39 years to accelerated over 7 or 15 years.

IRS challenged this change on audit, arguing that the change was inconsistent with allocations in the purchase agreement. Peco argued that the purchase agreements were ambiguous.

- Allocation to “Processing Plant Building” was determined by Tax Court to mean a single real estate asset.
Allocations in the agreement to three assets: “Real Property: Land,” “Real Property: Improvements”, and “Machinery, Equipment, Furniture and Fixtures”. Tax Court determined that the parties did not intend to allocate to subcomponent assets.

- If buyers intend to allocate based upon a cost seg study, they need to have sellers agree to this in the purchase agreement in clear language. If there is no clear agreement, both parties are risking adjustments on audit.

- Note: parties to purchase agreements are not required to agree on an allocation of purchase price, and there is no requirement to report consistently on their tax return.
ABC corporation acquired the assets of Target including a leasehold interest in a property used in the Target’s business. The rent owed under the lease was $1.1 million per year. ABC obtained appraisals that the fair market rent was $356,000 per year.

The lease contained a purchase option with the price to be the FMV of the property defined to include the value of the unexpired lease (40 years remaining). ABC exercised the option in 1997 at a $9 million price (after further negotiations, $11 million was paid in 1999). Valuation experts concluded that the property without the lease was worth $2.75 million. On its 1997 return, ABC deducted $6.25 million as a deductible lease termination expense.

ABC Beverage Corp. v. United States, 577 F. Supp 2d 935 (W.D. Mich. 2008), affirmed 2014 BL 164462 (6th Cir. 6-13-14). See also Cleveland Allerton Hotel, Inc. v. Com’r, 166 F. 2d 805 (6th Cir. 1948).
HOLDING PERIOD

- LTCG requires one year holding period. Need to watch bifurcation traps.
  - Holding period of Purchase Contract or Option does not tack with holding period of the real estate. Purchase Contract or Option could be a capital asset itself.
  - Newly constructed property could have LTCG for the land but short term for the improvements. See, e.g. Rev. Rul. 75-524, 1975-2 C.B. 342.
  - Partnership (LLC) interests could have bifurcated holding period under Treas. Reg. §1.1223-1(b) for capital contributions within 12 months of sale of interests.
  - Holding period for interests in a partnership or LLC could be different than holding period of real estate owned by that entity.
SPECIAL RULE: SECTION 1231

- Real estate used in a trade or business (not dealer property)
- Net 1231 gains are LTCG if held for one year
- Net 1231 losses are ordinary
- Note Recapture for net 1231 gains as ordinary to the extent of net 1231 losses in prior five years
- Assume Smith recognized net 1231 losses in 2011. Smith is a partner in XYZ Partnership that owns 1231 real property. If XYZ sells real property at a gain in 2013, Smith’s share will be ordinary income under the 1231 recapture rule to the extent of prior net 1231 losses. However, what if Smith sells his partnership interest? No authority that the partnership interest is 1231 property.
- Better position is that sale of LLC interest at a gain is not a 1231 recapture event.
PARTNERSHIPS AND LLCs

- General rule is that partnership interest is capital asset
- Section 751 “hot asset” rules
  - Inventory (including “dealer” property)
  - Unrealized receivables including recapture
  - Trade or business assets held less than one year
- Look through for 1250 Gain (25% rate), but note special rule for “redemptions” of interests (Treas. Reg. §1.1(h)-1).
- Look through for Collectibles Gain (28%)
- Seems to be no look through for Section 1231 or 1239. cf. Rev. Rul. 72-172, 1972-1 CB 265 (husband and wife transfer all partnership interests to related corp – 1239 applied) Also see Rev. Rul. 60-352, 1960-2 C.B. 208 (disposition of interest in partnership holding installment notes is acceleration event).
- Compare S corps - No look through for 1250 Gain
  - Look through for Collectibles Gain
- Note special rules (Rev. Rul. 99-5; Rev. Rul. 99-6) for going in and out of disregarded entity status.
AVOIDING SECTION 1239
ORDINARY INCOME

- S Corp owns an apartment complex worth $1 million with a basis of $1. The sole stockholder of S Corp was Smith. Smith dies and his basis in the stock of S Corp is stepped up to $1 million.

- Smith’s estate wants to liquidate S Corp. Liquidation of S Corp will trigger a deemed sale of the apartment complex to the estate.
  - If the gain is capital gain, the estate would pick up but with an offsetting capital loss on the liquidation.
  - Section 1239 causes sale of depreciable property to related party to be taxed at ordinary income. Not a good result!
  - Assume S Corp forms LLC with Y, a family member. S Corp contributes the apartment complex to LLC in exchange for an 80% LLC interest. Y contributes $250,000 cash in exchange for a 20% LLC interest.
  - S Corp liquidates and distributes the 80% LLC interest to the estate.
  - An LLC interest is not depreciable property. Is Section 1239 avoided?
  - Section 754 election produces basis step up for estate.
A and B are brothers. A and B own Blackacre as equal tenants in common. A and B also own the stock of AB Corp, an S Corporation, equally.

In 2016, B sold his interest in Blackacre to AB Corp in exchange for an installment note payable over five years in equal annual installments.

AB Corp resells its interest in Blackacre in 2017.

Under Section 453(e), if a taxpayer disposes of “property” to a related person and the related person disposes of “the property” before the taxpayer receives all payments under the installment note, the taxpayer’s gain is accelerated.

- To be a problem, second disposition of the property must be within two years of the first disposition.
- The amount of the gain accelerated is based upon the amount realized on the second disposition.

Here, AB Corp is a “related person” to B, so the disposition by AB Corp accelerates the installment gain to B even though B receives no money.
Suppose the facts change. A and B own AB LLC, AB LLC owns Blackacre. B sells his 50% interest in LLC to AB Corp in 2016. In 2017 AB LLC sells a 50% undivided interest in Blackacre to third party. Is B’s installment gain accelerated?

- B sold his LLC interest to AB Corp, not his interest in Blackacre.
- AB LLC’s sale of half of Blackacre should not accelerate any gain to B.
- The “property” disposed of by B was an LLC interest. Blackacre is not the same “property.”
Section 1239 – As discussed above, sale of less than 100% interests in LLC holding depreciable property should not trigger 1239. Note that there have been several legislative proposals to cause 1239 to apply (e.g., H.R. 1935, Sec. 3(a)(1)(a) (2009)). These efforts have failed. This supports the position that, under current law, there is no look through rule. Rev. Rul. 99-6 could also support this position notwithstanding Rev. Rul. 72-172.

Section 453(g) – Sale of depreciable property between related parties is not eligible for installment sale treatment. Does this apply to sale of interest in LLC that owns depreciable property?

- See Section 453(k) and Section 453A(e) which authorize the Secretary to issue regulations to prevent the use of sales of interests in pass-through entities to avoid certain installment sale restrictions. There is no similar language applicable to Section 453(g). Plus, no regs have been issued under these other provisions.

- See CCA 200722027. Section 751 is the only look through rule under Section 453. If no 751 assets, then presumably no look through.
Grecian Magnesite Mining v. Com’r, 149 T.C. No. 3 (2017) is a strong case for the entity approach to pass-through planning. Tax Court refused to follow Rev. Rul. 91-32, 1991-1 C.B. 107, where IRS concluded that gain on sale by non-U.S. partner of its partnership interest should be effectively connected U.S. income to the extent the partnership’s assets are used in a U.S. trade or business.

Tax Court reasoned that Section 741 and Section 731 exist to respect the Subchapter K general rule that a partnership interest is an asset separate and apart from the underlying partnership assets.

- Exception: Section 751 – “hot assets”
- Exception: Section 897(g) – partnership owns U.S. real property interest

The TCJA rejects the Tax Court conclusion in Grecian Magnesite Mining and adopts Rev. Rul. 91-32.

Note: For state tax purposes, tax can be avoided in many states where interests in LLCs and partnerships are sold by non-resident members/partners.
Example: LLC owns rental real estate in Maryland. LLC has some members who are Florida residents. If LLC sells assets, all members are subject to tax with non-residents subject to withholding. If members sell interests, the Florida residents do not have Maryland tax.

New Section 168(k) (100% deduction). Buyer buys tangible personal property from Seller LLC in 2018. Buyer can take 100% deduction. What if Buyer buys 99% of the LLC interests and LLC makes a Section 754 election. Does Buyer get 100% deduction? For the step up in basis? For the entire amount allocated to qualified property? For nothing? Prop. Reg. §1.168(k)-2(b)(3)(iv)(D) says only for the step up and provided Buyer never had an interest in LLC property and is an unrelated party.

Section 199A (20% deduction) – LLC operates a trade or business that generates qualified income eligible for 20% deduction. The deduction is applied at the partner level. What if a partner sells his partnership interest and the gain is subject to Section 751 ordinary income?

➢ Is this ordinary income subject to the 20% deduction? If not, the recapture would be at 37% even though the depreciation benefit was at 29%.

➢ Section 199A(b)(1)(B) and (e)(5)(B) provide a favorable result for qualified publicly-traded partnership gain under Section 751. Proposed Regs under Section 199A made clear that 751 recapture is QBI.
PARTNERSHIP “LOOK THROUGH”

Office LLC purchased an office building for $2 million. Office LLC’s current basis in the building is $1.2 million. The market value of the building is currently $3.5 million.

1. If C sells his interest for $1.4 million, what are the tax consequences to C?
   
   - The total gain at the Office LLC level is $2.3 million.
   - The total amount subject to recapture is $2 million (original cost) less the adjusted basis of $1.2 million. The difference ($800,000) represents depreciation subject to recapture at the rate set forth in Section 1(h) (generally 25%). C’s share of Section 1250 gain is $320,000 (40% x $800,000), calculated by determining the amount of the partnership Section 1250 gain that would be allocated to C had the LLC sold the property for its fair market value. The remaining share of C’s gain ($600,000) is taxed at the 20% capital gains rate. See Treas. Reg. § 1.1(h)-1(a).
2. If C had recognized Section 1231 losses during the 5-year period preceding the sale of his interest, would there be Section 1231 recapture?
   ▪ C is not subject to Section 1231 loss recapture on the sale of his LLC interest. However, C would be subject to recapture had Office LLC sold the property. Section 1231(c).

3. What would be the result if Office LLC were instead an S Corp.?
   ▪ Treas. Reg. § 1.1(h)-1(a) provides that when stock of an S corporation held for more than a year is sold or exchanged, the transferor may recognize ordinary income, collectibles gain and residual long-term capital gain or loss but does not mention Section 1250 gain (as the same regulation does in the context of a sale of a partnership interest). Thus, C would not be subject to recapture had he sold an interest in an S corporation.

4. If C’s interest were “redeemed” by Office LLC, C would not be subject to 25% recapture. Treas. Reg. §1.1(h)-1 provides that there is no “look through” in a transaction treated as a redemption of a partnership interest.
ABANDONMENT LOSS: ORDINARY OR CAPITAL?

- Pilgrim’s Pride Corp v. Com’r, No 14-60295 (5th Cir 2015), rev. 141 T.C. No 17 (2013). In 1998, Taxpayer sold a business to Buyer. Buyer financed the purchase with a short-term bridge loan while planning to go public. If Buyer failed to go public, Taxpayer committed to purchase preferred stock from Buyer for $98.6 million. Taxpayer purchased the preferred stock.

- In 2004, Taxpayer and Buyer attempted to negotiate a redemption price for the preferred stock. Taxpayer wanted $31.5 million; Buyer offered $20 million. Instead of accepting the $20 million offer, Taxpayer abandoned the preferred stock for no consideration.

- If Taxpayer had accepted the $20 million offer, it would have recognized a $78.6 million capital loss on the sale. On the abandonment, Taxpayer took a $98.6 million ordinary loss under Section 165. After Taxpayer went bankrupt several years later, Service challenged the ordinary loss treatment.

- Taxpayer argued that ordinary loss treatment was correct because no “sale or exchange.” Tax Court ruled in favor of the Service based upon Section 1234A which applies capital loss treatment when there is a termination of rights with respect to a capital asset.
On appeal, the Fifth Circuit reversed the Tax Court concluding that an abandonment loss is not a loss “attributable to the cancellation, lapse, expiration or other termination of …a right or obligation …with respect to [a capital asset]” as required by Section 1234A(1). Abandonment of the property itself is distinguished from abandonment of a “right” with respect to the property.

When a partner (or member) holds an interest in an entity that is failing, he has several options.

- Hold the interest until the entity is liquidated and take a capital loss equal to excess of basis over amount realized (note: basis may be low due to prior losses).
- Sell the interest to a third party and trigger a capital loss.
- “Abandon” the interest and trigger a loss which could be ordinary or capital depending on the facts.
- Claim a “worthless” partnership interest loss which may be ordinary or capital depending on the facts.
Rev. Rul. 93-80, 1993-2 C.B. 239 – Abandonment of a partnership interest triggers an ordinary loss if there is no actual or deemed sale or exchange. If the partner shares in partnership recourse or nonrecourse debt, capital loss will be the result. See also Citron v. Com’r, 97 T.C. 200 (1991); Echols v. Com’r, 935 F.2d 703 (5th Cir. 1991).

Note: worthlessness and abandonment are two separate and distinct concepts as Pilgrims Pride demonstrates. See also Echols v. Com’r, 950 F.2d 209 (5th Cir. 1991) (per curiam) (“Echols II”).

In a partnership where the value of assets is less than nonrecourse debt, is the partnership interest worthless so that an ordinary loss can be triggered because there has been no sale or exchange? Commentators have offered strong arguments for this position based upon Echols and Echols II. When the partner has personal liability for recourse debt, compare Proesel v. Com’r, 77 T.C. 992 (1981) with In Re Kreidle, 91-2 USTC II 50,371 (Bankr. D. Col 1991), aff’d 143 B.R. 941 (D. Col 1992). See also Tucker v. Com’r, T.C. Mem. 2015-185 (with recourse debt, no abandonment or worthless loss deduction; loss only available in year of Foreclosure or other disposition).

David Greenberg v. Com’r, T.C. Mem. 2018-74; to have abandonment loss, taxpayer must prove (i) it owned the abandoned property, (ii) it intended to abandon and (iii) it took affirmative action to abandon, citing Citron (above). Taxpayers failed to prove ownership.

Taxpayers claimed ordinary loss deduction (§165) on abandonment of partnership interest. Court determined that taxpayers had no basis in partnership interest, thus zero deduction.

Example: Partner contributes $1,000 to Partnership as initial capital contribution. Year 1, Partner is allocated $3,000 loss. Partner does not share in Partnership debt so Partner deducts $1,000 of loss and remaining $2,000 is suspended. Partner’s basis stops at zero (no “negative basis”). Year 2, Partner is allocated $1,000 of income. Partner abandons interest at end of Year 2. Partner argues his basis is $1,000. Government argues basis is zero.

Court determines basis is zero, thus no abandonment loss.
FORFEITED DEPOSIT = ORDINARY INCOME

- **CRI-Leslie LLC, 147 T.C. No. 8 (9-7-16).**

- Taxpayer purchased a hotel on 2-25-05 for $13.8 million. Taxpayer operated the hotel thereafter. On 7-10-06, Taxpayer entered into a contract of sale with a third party buyer for $39 million.

- Buyer paid Taxpayer a $9.7 million deposit. If the transaction had closed, this deposit would have been applied against the purchase price. The transaction did not close and the deposit was forfeited by the Buyer and retained by Taxpayer in 2008.

- Taxpayer treated as long term capital gain. IRS contended ordinary income, Tax Court agrees with IRS.

- Parties agreed that the hotel was property used in a trade or business under Section 1231(b)(1).

- Section 1234A provides for capital gain treatment in case of a cancellation lapse, expiration or other termination of a right with respect to property that is a “capital asset” in the hands of the Taxpayer.

- Tax Court determines that capital asset does not include Section 1231 property. If Congress intended to cover 1231 property, it would have expressly so provided.

- Eleventh Circuit affirmed the Tax Court. **CRI-Leslie LLC v. Com’r** No. 16-17424 (2-15-18).
This Tax Court Memorandum decision is a judicial masterpiece—a must read. Owens v. Com’r, T.C. Mem. 2017-157 (August 10, 2017) (Judge Holmes).

Taxpayer’s father started a successful moneylending business that Taxpayer took over (Owens Financial Group, Inc. – “OFG”). Taxpayer was President and a majority stockholder. OFG made mortgage backed loans and bridge loans to businesses. Loans originated by OFG were funded by Owens Mortgage Investment Fund, a limited partnership in which OFG was general partner.

In addition to the OFG activities, Taxpayer made many loans from his revocable trust and sometimes from an FLP that he managed with his sisters. From 1999 to 2013, Taxpayer made approximately 90 loans personally or through the revocable trust or the FLP.

Taxpayer did not have a separate office for his personal lending activities nor did he have employees devoted to his personal activities. All overhead was OFG’s.
In 2002, Taxpayer met Lohrey who was in the laundry business. Lohrey’s business went bankrupt and he had an opportunity to buy it out of bankruptcy. Lohrey borrowed $7.5 million from OFG but Lohrey needed more. Taxpayer agreed to bridge the gap with loans made by Taxpayer personally. Initially, this was a $2.75 million second mortgage, 15% rate and maturity in 2005. It also had an equity kicker.

In 2005, Lohrey fell behind and Taxpayer was admitted to an LLC between Taxpayer and Lohrey (“Lohrey Investments”). Ultimately, Taxpayer loaned $16 million to Lohrey. Taxpayer was allocated $4 million of losses in 2006 and $2.8 million in 2007. Taxpayer deducted these losses against his share of the debt.

Lohrey still needed more money. Vestin Mortgage would lend $20 million to Lohrey if Taxpayer subordinated. Part of the $20 million that was used to repay OFG.

Lohrey went bankrupt in 2009 and Taxpayer received nothing when the bankruptcy case closed in 2010. The Lohreys individually guaranteed the loans. They went bankrupt as well.
Section 166 permits a bad debt deduction (ordinary) if:

- Taxpayer was in a trade or business
- The loans were bona fide debt
- The debt became worthless

Taxpayer deducted his loss as a Section 166 bad debt on Schedule C for 2008. IRS challenged this treatment.

Tax Court found that Taxpayer was personally in the trade or business of making loans. Taxpayer was in the regular and continues business of making loans. The fact that he did not operate separately from OFG was irrelevant.

Tax Court found that the debt was bona fide. Terms were clearly debt. Service argued Taxpayer’s admission to Lohrey Investments indicates debt was converted to equity, plus Taxpayer’s subordination indicated equity. Tax Court found intent of parties that loans remained debt.

Tax Court found that debt became worthless in 2008. IRS said bankruptcy filing in 2009 was the first time there could be a position of worthlessness.
Tax Court concluded that worthlessness can be determined based upon a variety of factors:

- decline in debtor’s business
- overall business climate
- insolvency of debtor

Lohrey told Taxpayer in 2008 he was going bankrupt. Taxpayer knew in 2008 he would be wiped out by the Vestin first mortgage.
HARVESTING TAX LOSSES

- Loss Corp retains option to purchase less than 50% of the assets (does not have option to purchase LLC interests)
- Loss Corp retains management rights and receives fees
- Loss Corp has right of first refusal over certain assets
- Loss Corp receives disproportionate distributions if certain benchmarks are exceeded.

Property Sale
$10 mil value
$20 mil A/B

Loss Corp

Cash
10 million

20% interest
50% vote
$2 million

80% interest
50% vote
$8 million

Loss Corp PE

JV

10 million

$10 mil value
$20 mil A/B

$2 million

$8 million
HARVESTING TAX LOSSES (CONT’D)

- Is it a “sale” for tax purposes?
  - Is it a capital contribution and a distribution? If a capital contribution, Loss Corp would have a basis of $22 million and a cash distribution of $10 million so no loss recognition.
  - Do the “benefit and burdens” of ownership pass to the JV? What are the terms of the option? No requirement or economic compulsion.

- If a “sale” then the ordinary tax loss would be carried back by Loss Corp to get a refund. Generally two years. Recent legislation permits NOLs in 2008 or 2009 to be carried back up to five years (with 50% of taxable income limit for fifth year unless “small business”).

- Does not work if Section 267 or Section 707(b)(1) apply. OK if Loss Corp owns less than 50% of capital and profits of JV, subject to attribution rules.

- Even if it is a “sale”, could the government argue that no loss is recognized to the extent Loss Corp has “preformation expenditures” under the disguised sale rules?
HARVESTING TAX LOSSES (CONT’D)

- Treas. Reg. §1.707-4(d)- transfer of money by a partnership to a partner is not treated as part of a sale of property to the extent the transfer to the partner by the partnership is made to reimburse the partner for, and does not exceed the amount of, capital expenditures that:
  
  i. are incurred within 2 years of the transfer and
  ii. are incurred by the partner with respect to the property “contributed” to the partnership by the partner.

- Treas. Reg. §1.704-4(d)- only provides reimbursement treatment to the extent capital expenditures do not exceed 20% of the FMV of property. However, this limitation does not apply if FMV of property does not exceed 120% of the partner’s adjusted basis in the contributed property.
Form is important. Separate Purchase and Sale Agreement

In Lennar/Morgan Stanley deal, Purchase and Sale Agreement provides:

“9.6 Intended Tax Treatment. The Parties agree that the purchases of the Properties…shall be treated as taxable purchases for U.S. federal and state tax purposes to the maximum permissible extent and that no portion of the cash paid by the Purchaser is intended to or shall constitute reimbursement of pre-formation capital expenditures within the meaning of Treas. Reg. §1.707-4(d).”
“DEALER” STATUS

- Whether property is “dealer” property (i.e., held primarily for sale to customers in ordinary course of business) is a question of fact looking at the nature of the property involved, as well as the prior and current activities of the owners of the property.

- An individual could be a dealer with respect to certain property and an “investor” with respect to other property. Separate entities could help. Note: For property sold at a loss, taxpayer will argue he was a dealer.

- Factors to consider:
  - Marketing, pre-sale activities
  - Status of entitlements, record plats, etc.
  - Duration and history of holdings of property
  - Number of sales [sale to one buyer in one transaction]
  - Frequency of sales [“liquidation of investment” theory]
  - Intent/purpose at time of purchase of property; change in circumstances
  - Improvements made in context of sales [breaking ground/infrastructure]
Patricia and Donald Flood, T.C. Mem. 2012-243 (August 27, 2012). The Floods lived in Florida where Mr. Flood was a “day trader in the stock market.” The Floods also engaged in various real estate transactions between 2001 and 2008 when they purchased at least 250 lots. During 2004 they sold 2 lots and during 2005 they sold 40 lots and gave 11 lots to their church. The government argued that the Floods were “dealers”. The Tax Court agreed.

- Floods argued they were investors. Court was influenced by a variety of factors- Frequency of transactions, amount of profit on real estate versus day trading (?), extent the Floods were actively involved in research, marketing, etc.
- Mr. Flood engaged and supervised real estate agent, title company, etc. He marketed properties on his website and placed ads in grocery stores.

Phillip Sutton, T.C. Summ. Op 2013-6 (Feb. 6, 2013) – Loss from abandonment of option to purchase property was ordinary loss because the property subject to the option would have been held by the taxpayer as dealer property if it had been acquired by the taxpayer. Note taxpayer argued he was a dealer and government argued taxpayer was an investor!


**“DEALER” STATUS (CONT’D)**

- **Long v. Com’r**, No 14-10288 (11th Cir 2014) (per curiam), aff’g and rev’g T.C. Mem. 2013-233. Taxpayer owned a contract right to purchase land. Taxpayer sold the contract to a third party for $5.75 million and treated the gain as long term capital gain. Tax Court held that, because Taxpayer had intended to sell the land if he had closed on the purchase, the land would have been dealer property and, for this reason, dealer status was imputed to the sale of the contract. The 11th Court rejected this analysis and concluded that the contract to purchase and the underlying land were two separate assets that could have different tax character. Does this mean Sutton is wrong?

- **Boree v. Com’r**, T.C. Mem. 2014-85. Change in purpose and bulk sales did not protect Taxpayer from dealer status. Taxpayer bought 1900 acres. It sold 280 acres in bulk while developing and selling some lots on the remaining property. Ultimately Taxpayer sold the remaining 1067 acres in bulk because it did not want to expend funds for roads. This final sale was determined by Tax Court to generate ordinary income.
Fargo et al v. Com’r, T.C. Mem. 2015-96. An affiliate of Taxpayer purchased a leasehold interest in 2.2 acres in 1989 with intent to construct apartments and retail space. In 1991, Taxpayer was assigned the leasehold and purchased the fee from unrelated seller. In 2001, Centex Homes made an unsolicited offer and Taxpayer sold the property. Because Taxpayer purchased the property with intent to develop it and never abandoned this plan, even though it never did develop it, Tax Court concluded Taxpayer held the property for sale.

SI Boo LLC v. Com’r, T.C. Mem. 2015-19. Taxpayer acquired tax liens on various properties. If liens were not redeemed, Taxpayer would acquire the underlying properties and sell them. Tax Court treated Taxpayer as a dealer because of the frequency of the acquisitions and sales (over 250).

Levitz v. Com’r, T.C. Summ. Op. 2018-10 (No. 15393-145). Taxpayer argued that losses on real estate sales were ordinary because he was in the business of real estate. Government argued he was an investor. Tax Court found capital loss.

For Taxpayer victories, see, e.g., Rice v. Com’r, T.C. Mem. 2009-142; Phelan v. Com’r, T.C. Mem. 2004-206; Gardner v. Com’r, T.C. Mem. 2011-137.
Sugar Land Ranch Development LLC, T.C. Mem. 2018-21, is a taxpayer victory.

SLRD was formed in 1998 to acquire large, contiguous tracts of land in Sugar Land, Texas for development into single-family residential building lots and commercial tracts.

Between 1998 and 2008, SLRD sold some small portions of the property. In 2008, SLRD stopped subdivision and development because of the economic downturn. From 2008 to 2012, there was no activity.

In 2012, SLRD sold 3 parcels to a homebuilder. Thereafter, SLRD transferred the balance of the property to affiliates for no consideration.

SLRD tax returns reported the principal business activity as “Development.” SLRD reported the 2012 sales as capital gain. The Tax Court noted that appeal would be to the Fifth Circuit and used precedent from the Fifth Circuit to establish the test for dealer status.
The Tax Court found that the taxpayers ceased holding the land primarily for sale in 2008 and when parcels were sold in 2012 that these sales were not in the ordinary course of business.

- SLRD did not market the parcels, did not solicit purchasers and did not devote time or effort to selling the parcels.
- The buyer had approached SLRD.
- The parcels were contiguous and there was a single sale to a single buyer.

Also important was that the development activity of SLRD’s affiliates should not “taint” the status of SLRD as an investor, citing Bramblett, Phelan and Suburban Realty.
On appeal to the 11th Circuit, the decision of the Tax Court was affirmed on the dealer issue. However, the 11th Circuit rejected the application of a 20% penalty because of “reasonable cause and good faith.” Boree v. Com’r, 2016 BL 296399 (11th Cir; September 12, 2016).

On the dealer issue the 11th Circuit focused on the taxpayer’s deduction of expenses as business expenses over several years. The court found this inconsistent with “investment status.”

On the penalty issue, the 11th Circuit acknowledged that a taxpayer may avoid the penalty where there was reasonable reliance in good faith on the advice of an independent tax advisor; the taxpayer’s education and experience are also relevant. Taxpayer was a former logger with no accounting experience. He relied on the CPA for years. The CPA was a professor at University of Florida College of Law who was viewed as an expert.
Assume A has held property X for more than one year. Property X consists of undeveloped land that A holds for investment. X is worth $250,000 undeveloped and A’s adjusted basis in X is $10,000. X is worth $600,000 when subdivided into several lots.

Assume that A, B and C are equal members of LLC and have owned their interests for 10 years.

1. If A subdivides the land and sells the lots to third parties, what is the result?

2. If A sells the undeveloped land to LLC, what is the result?
SALE OF POTENTIAL DEALER PROPERTY TO AN LLC (CONT’D)

- If A subdivides the land and sells the lots to third parties, what is the result?
  - The subdivided land will be dealer property, A will recognize ordinary income in the amount of $590,000. Sec. 1221(a)(1).

- If A sells the undeveloped land to LLC, what is the result?
  - A can avoid ordinary income on the first $240,000 of the gain by selling the undeveloped land to LLC if LLC pays $250,000 (its FMV) for property X. It is important to ensure that the sale of X to LLC is treated as a sale rather than as a capital contribution. The Service will be more likely to treat the sale as a capital contribution if LLC pays for X with an installment note rather than cash or if the LLC pays an inflated price. If the sale is respected and A does not own (directly or indirectly) more than 50% of the capital interest or profits interest in LLC, A should recognize $240,000 of capital gain, and LLC will take a basis of $250,000 in X.
- A sells the undeveloped land to a related S Corporation for $250,000 in notes.
- What are the tax consequences?
- What steps can be taken to bolster the taxpayer’s position?
- What if X sells interests in an LLC?
- A’s gain is capital gain as long as the form of the transaction is respected. The
determination will turn on whether the corporation pays FMV for X rather than an
inflated price. If the purchase price is paid by issuing an installment note, the
determination hinges on the FMV of the property and whether the corporation has
sufficient capital to pay the obligation. See, e.g., Aqualane Shores Inc. v.
Commissioner, 269 F.2d 116 (5th Cir. 1959); Bradshaw v. United States, 683 F.2d 365
(Ct. Cl. 1982); Bramblett v. Commissioner, 960 F.2d 526 (5th Cir. 1992).

- The tendency in this situation is to inflate the purchase price to maximize capital gain
and minimize ordinary income after the property is developed. If this occurs, the
transfer by a controlling shareholder may be treated as a contribution of capital to the
corporation rather than a sale. See Burr Oaks Corp. v. Commissioner, 365 F.2d 24 (7th
Cir. 1966), cert. denied, 385 U.S. 1007 (1967).

- What steps can be taken to bolster the taxpayer’s position?
  - Have some equity contribution.
  - Make sure S Corp. is held out to the public as the developing entity and not merely serving as A’s
    agent.
Pool v. Com’r, T.C. Mem. 2014-3, involved a related party sale at an inflated purchase price where Taxpayer lost.

Concinnity, LLC, in which Taxpayer was a member, purchased 300 acres for $1.4 million in 2000. The land was already divided into four sections or phases. Concinnity then entered into an agreement with Elk Grove Development (“Elk”) where Elk had the right to purchase three phases consisting of 300 lots. Elk and Concinnity had identical ownership.

Nature of Property Acquisition. Concinnity’s Form 1065 for 2000 identified its principal business activity as “development.” (Note that in 2001-7, the Form 1065 said “investment”). In 2001, Concinnity delivered an affidavit to the county that said (i) it is the developer of proposed subdivision and (ii) as of June 13, 2001, it has “entered into buy-sell agreements for the sale of 81 lots in phase 1 at an average price of $41,000.” This factor goes to Government.
Frequency and Continuity of Sales. The facts were unclear on this issue. It was not clear whether the sale of 81 lots was to Elk or to third parties. However, the Elk option agreement provided for a total sale price of $7.6 million and that the first 40 lots in phase 1 would be sold to Elk for $5,000 per lot, then $18,000 for next 60 lots and $32,000 for remaining phase 1 lots. The reference to $41,000 per lot suggested that Concinnity had “bypassed” Elk. These facts weighed against Taxpayer.

Nature and Extent of Business. Evidence suggested that Concinnity found buyers for lots, secured the water and wastewater systems and guaranteed performance on the improvements agreement. Taxpayer failed to provide evidence to explain the sale of the 81 lots. Plus Concinnity arranged a mortgage loan of $725,000 that covered the 300 acres including phase 1 which it had purportedly sold to Elk. These facts weighed against Taxpayer.

Extent and Substantiality of Transaction. Government argued that the “interlocking participation” of Concinnity and Elk was evidence that Elk was used principally to “evade or defeat Federal income tax.” Tax Court says “We do not agree that the identical ownership between two companies dooms this transaction.” Citing Phelan v. Com’r, T.C. Mem. 2004-206, where the Tax Court found a business purpose of protecting the seller’s remaining assets from any action brought against the identically owned development company.
In Pool, Tax Court concluded: “The same business purpose exists here.” However, Court found that the Elk purchase option at $7.6 million was inflated and there was no evidence to justify it when the property had just been purchased for $1.4 million for all 4 phases. It was also “noteworthy” that as part of the Elk purchase agreement, the parties had provided the development costs that Elk would incur. Why would Concinnity, as an “investor” have cared about the development costs? All of these facts weighed against Taxpayer.

Taxpayer liable for penalties. Section 6651(a).
RESTRUCTURING THE TRANSACTION

- What happens if, after the sale, the economic environment changes? There are no homebuilders who want to buy lots.

- Can the S corporation request a purchase price adjustment? Can the terms of the promissory note be changed?
  
  ➢ Section 108(e)(5) – can treat debt reduction where seller is the creditor and purchaser is debtor as a purchase price adjustment and not as COD. Note this is not available when purchaser is insolvent. This should mean “to the extent” purchaser is insolvent. See Ltr. Rul. 9037033.
  
  ➢ Section 453B(f) – if an installment obligation “is canceled or otherwise becomes unenforceable” the installment note is treated as if it were “disposed of in a transaction other than a sale or exchange”. Where sale was between related parties (as defined in 453(f)) face amount of canceled debt is amount realized. Unclear how this applies when there is a partial cancellation of installment debt. See Ltr. Rul. 8739045 which ignored this provision and treated as a non-acceleration purchase price adjustment.

- Can the S corporation sell the property to a non-related party and trigger an ordinary loss? Will the S stockholders have basis to take the loss? What about two year rule and Section 453?
Developers frequently are required by local governments to contribute a portion of the land to the local government so that it will be maintained as open space or used for schools or other public purposes. This land will have a tax basis (a portion of the developer’s total land costs) and a fair market value typically greater than basis.

There are several ways the developer’s contribution could be treated from a tax perspective:

1. Could the developer take the position that no basis is allocable to the donated land and any such costs should be allocated to the basis of the remaining property?
2. Could the developer take the position that the basis allocated to the donated land is deductible as a Section 162 business expense?
3. Could the developer take the position that the fair market value of the donated land is deductible as a Section 162 business expense?
4. Could the developer take the position that the basis allocated to the donated land is a charitable contribution under Section 170?
5. Could the developer take the position that the fair market value of the donated land is a charitable contribution under Section 170?

- In *Triumph Mixed Use Investments III LLC v. Com’r*, T.C. Mem. 2018-65, the developer went with No. 5 above and lost.

  - Developer was one of a group of entities that were developing a master-planned community on their land.

  - The land was purchased in 2000. At that time, the city council approved an area plan where half of the property would be developed into residential and commercial use and the remainder would remain open space.

  - In 2011, the developer had received approval from the Development Review Board to substantially increase the number of development units but there was community resistance. After various changes, the developer entered into an agreement pursuant to which certain property would be donated to the city as a charitable contribution for no consideration. At the time of the donation there was no assurance that the city would provide future approvals for the property.
Subsequently, the city council approved the development plan.

- Taxpayer obtained a valuation that the donated property was worth $11 million using a “before and after” approach. No value was included for consideration received.
- Taxpayer included Form 8283 on its return showing the transfer of land and development credits to the city. The appraisal was attached. No consideration received was reported.
- IRS argued:
  1. No charitable deduction because there was a quid pro quo of receiving development approvals.
  2. No qualified appraisal.
  3. The city’s contemporaneous acknowledgement did not value the consideration received.
  4. The value was overstated.

- The Tax Court concluded no charitable contribution because of the quid pro quo arrangement. The transfer occurred to satisfy the city’s demand for more open space.

- See also Seventeen Seventy Sherman St., LLC v. Com’r, T.C. Mem. 2014-124; Pollard v. Com’r, T.C. Mem. 2013-38.
Wendell Falls Development, LLC v. Com’r, T.C. Mem. 2018-45, where Taxpayer donated a conservation easement on land before sale to town. Land was to be used as a county park with rest of land to be developed under a PUD.

Taxpayer had a valuation expert and IRS had a valuation expert. Each valued the easement.

Tax Court ignored both valuations and concluded the charitable contribution was $0 because Taxpayer expected a substantial benefit to the development project through enhanced property values caused by the park.

Under the development plan, the best use of the park land was as a park in the middle of the master planned community. The easement did not prevent this land from being put to its best use.

“Before and after” valuation = zero.
TRADE OR BUSINESS vs. INVESTMENT PROPERTY

- Barry G. Conner v. Com’r, T.C. Mem. 2018-6, where Taxpayer owned various properties and took the position he was engaged in a trade or business but IRS argued he was a mere investor.

- Taxpayer’s loss on land sale was capital loss. The land was sold in a single sale. They never marketed the property or employed a broker. The sale was unsolicited.

- Taxpayer incurred expenses that were deducted under Section 162. Court concluded only deductible under Section 212 and Section 163(d).

- Taxpayer took a charitable contribution for a bargain sale of land to a charity - excess of value over amount paid. IRS argued this was land held for sale (deduction = basis less sales proceeds). Court finds investment property (FMV less sales proceeds).
FAMILY OFFICE = TRADE OR BUSINESS

- Lender Management, LLC v Com’r, T.C. Mem. 2017-246, where a “family office” that managed investments for the heirs of Lender Bagels was found to be engaged in a trade or business and not merely an investor.
  - Trade or business permits expenses to be deducted under Section 162. Deducted from gross income.
  - IRS contended these expenses were only deductible under Section 212. Deducted from adjusted gross income and, prior to TCJA, subject to a Section 67(a) “floor.” After TCJA, many investment expenses are nondeductible.

- In Lender, the Management Company provided direct management services to three Lender family investment LLCs. The LLCs invested in equities, hedge funds and private equity.

- Each investment LLC had the Management Company as sole manager. The Management Company received a carried interest that was attributable to investment profits.

- The Management Company had five employees, including a non-family member CFO. The Management Company engaged an unrelated company to provide accounting, tax and investment advisory services.
The Tax Court found that the Management Company was engaged in an active business of providing investment advisory services.

- The Management Company received, through its carried interest, returns that were greater than “normal investor’s returns.”

- A positive fact was that the Management Company provided investment advisory services to unrelated entities as well as to entities controlled by the family.

Is having unrelated clients crucial to this positive result? The operating agreement provided that the purpose was to provide management services including to “third party nonfamily” entities.

Important facts: (1) Employees of Management Company were full time and the lead officer was an investment expert, (2) ownership of the Management Company did not mirror ownership of the family investment entities.

See also Dagres v. Com’r, 136 T.C. 263.
Shea Homes Inc., 142 T.C. No. 3 (2014); The Howard Hughes Company, LLC, 142 T.C. No. 20 (2014). Shea Homes Inc. was affirmed by the 9th Circuit. Shea Homes Inc. v. Com’r, 2016 BL 274845 (9th Cir., August 24, 2016).

General Rule: A “long term contract” is subject to “percentage of completion” method of recognizing income and expenses. Home builders would include a portion of total contract price in gross income as the taxpayer incurs allocable contract costs (cost-to-cost method—percentage of a contract completed during a taxable year is determined by contract costs incurred during the year to total contract costs). Treas. Reg. § 1.460-4(b)(1).

Exception: Certain “home construction contracts” permit use of “completed contract method” where income and expenses are recognized when the entire contract is complete. Section 460(e).

In Shea Homes, the taxpayer was permitted to use the completed contract method in accounting for the income and expenses of developing a large residential community. The taxpayer was responsible for building and selling houses in the development as well as for completing the infrastructure and common amenities such as pools, golf courses and clubhouses. The Tax Court concluded that the contract was not “completed” until 95% of all costs to complete the common improvements were incurred (final road paving and bond release).

In Howard Hughes Co., however, the Tax Court concluded that the taxpayer’s contracts were not “home construction contracts” under Section 460(e). Taxpayers did not build the dwelling units on the land they sold.
IMPORTANCE OF BASIS IN PARTNERSHIP INTEREST

- Utilization of Losses
  - § 704(d)
- Tax-Free Extraction of Cash
  - § 731
- Interaction with Disguised Sale Rules
  - Treas. Reg. § 1.707-5
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<th>§704(b) Book Capital Accounts</th>
<th>Tax Capital Accounts</th>
<th>Outside Tax Basis</th>
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GENERAL RULE OF THUMB

- Tax Capital Account Plus Share of Partnership Liabilities = Outside Tax Basis
- S Corp stockholder gets basis for his capital contributions, his loans to S Corp and his share of undistributed income.
- Stockholder’s basis is **not** increased by S Corp debt. This is potential tax trap.
- Stockholder guaranty of S Corp debt does not increase basis.
- To boost basis, S Corp stockholder must borrow personally “outside” and lend/contribute funds to S Corp.
- See Treas. Reg. §§1.1366-2 (final 7-23-14) regarding back-to-back loans and guarantees.
SH contributes Asset A to S Corp. Asset A has a basis and a value of $100. SH gets basis of $100 in his stock and S Corp retains $100 basis in Asset A. Asset A declines in value to $90. Asset A is distributed to SH.

SH reduces his stock basis by $90 to $10. Asset A has a basis of $90 in the hands of SH.

Section 311(a) provides that gain is recognized on a distribution of appreciated property from a corporation (including an S Corp), but loss is not recognized in this circumstance.

Is SH required to reduce his stock basis to $0? Yes. ILM201421015 (5-23-14). A Section 311(a) loss is treated as a non-deductible, non-capital expense under Section 1367(a)(2)(D). Thus SH’s basis and AAA are reduced by the unrecognized loss. See also Ltr. Rul. 8908016.

Note: This is a permanent loss of basis.

Compare: If Asset A were sold by S Corp for $90, SH would receive a $10 loss.
Section 704(d) limits a partner’s ability to deduct his share of partnership losses to basis. Excess losses are suspended and carried forward until the partner’s basis is increased. The same rule applies to stockholders of S corporations under Sections 1366(d) and 1367.

In *Barnes v. U.S.*, 2013-1 USTC ¶50,267 (4/5/13), affirming 103 T.C. Mem. 1424 (2012), The D.C. Circuit agreed with the Tax Court that an S stockholder must reduce stock basis in the first year that basis is available to absorb suspended losses. This is true even if the stockholder fails to deduct the loss in that taxable year [similar to “allowed or allowable” for depreciation].
Taxpayer had losses prior to 1997 from an S corporation and some of these losses were suspended because of basis limitations. In 1997, the taxpayer’s basis in the stock increased but the taxpayer failed to apply his suspended losses against basis that year (either on an original return or an amended return).

In 2003, the taxpayer deducted $280,000 of losses from the S corporation because he thought his stock basis was $280,000. However, on audit the government disallowed $125,000 of these losses because they could have been taken in 1997.
Taxpayer argued that in 1997, if no deduction was claimed, then the stock basis was not reduced. Court rejects this view. Note that the statute had run on 1997. Of course, the $125,000 disallowed loss can be carried forward.

To add insult to injury a Section 6662 substantial understatement penalty was also imposed.

Generally S corporation income (including tax exempt income) increases stock basis. Taxpayer contended that a QSUB election for a subsidiary triggers “income” that increases stock basis in parent S corporation’s stock.

A QSUB election is treated as a liquidation of the subsidiary under Section 332. Section 332 provides that this liquidation does not cause built in gain in the QSUB to be recognized.

Taxpayer contended that the built in gain in the QSUB was “tax exempt income” or income analogous to COD (see Gitlitz v. Com’r, 531 U.S. 206 (2001)). Tax Court rejected this argument.
The taxpayer’s position would convert the single level of taxation of an S corporation into a zero level of taxation. If taxpayer had won:

- Presumably, no duplicate basis boost on gain subsequently recognized by S corp attributable to QSUB.
- Possible character difference would still exist (e.g. QSUB recapture assets).
- 1374 would still be applicable for 10 years.

Note government waived accuracy-related penalties!! This is even though taxpayers attempted to boost basis by $240 million.
It is clear that an S corporation stockholder does not boost basis by guarantying corporate debt.

Only when the facts demonstrate that, in substance, the stockholder borrowed funds and then advanced them to the corporation does the stock basis increase. See Selfe v. U.S., 778 F.2d 769 (11th Cir. 1985); Sieiman v. Com’r, 197 F.3d 1352 (11th Cir. 1999).

In Phillips v. Com’r, No. 17-14439 (11th Cir., 5-17-18), the 11th Circuit, on appeal from the Tax Court, considered this issue where the S corporation had defaulted on substantial real estate loans that were guaranteed by the Taxpayer, a stockholder.

In fact, the lenders had gotten judgments ordering the sale of the property and finding that the stockholders, including the Taxpayer, were jointly and severally liable as guarantors. During the years involved, Taxpayer had not made any payment on the debt.

Taxpayer does not get basis boost unless “actual economic outlay.”
LOANS BETWEEN AFFILIATES AND S BASIS

- **Meruelo v. Com’r, T. C. Mem. 2018-16**

- Taxpayer was a real estate developer and held interests in many entities including S corporations.

- Taxpayer’s entities had “hundreds” of “due to/due froms.” Taxpayer incurred substantial losses from one S corporation and took the position that loans from affiliates to the S corporation were actually loans first to the Taxpayer who in turn loaned the funds to the S corporation.

- To boost basis, the Taxpayer requires proof of bona fide indebtedness of the S corporation that runs directly to the shareholder. The shareholder must have made an “actual economic outlay.”

- Taxpayer loses. Documentation fails to evidence bona fide “back to back loans.” Loans from one pass-through entity to an S corporation affiliate do not boost basis.

- See also **Messina v. Com’r, T. C. Mem. 2017-213** where, on similar facts, Taxpayer argued affiliate was mere agent of Taxpayer. Taxpayer loses. No basis boost.
In the partnership context, a partner’s contribution of a self-created note (or a deferred capital contribution obligation) does not increase basis unless this personal recourse obligation causes partnership recourse debt to be allocated to that partner under Section 752.

In the corporate context, can a self-created note protect a stockholder from triggering gain under Section 357(c) in a Section 351 transaction? In Peracchi v. Com’r, 143 F.3d 487 (9th Cir. 1998), the Ninth Circuit concluded yes.

Taxpayer contributes a note equal to liabilities in excess of basis. Ninth Circuit concluded that a third party creditor can collect on the note. Therefore, it increases basis.

A, B and C form an LLC. C agrees to contribute and lend substantial funds to LLC if A and B contribute their personal recourse notes to LLC. A and B receive legal advice that the notes create basis.


Taxpayer argued the notes were analogous to Gefen, 87 T.C. 1471 (1986) where taxpayer assumed partnership recourse debt. Tax Court concluded that A and B were not assuming or guarantying debt of the LLC.

What about the loan made by C to LLC? Were A and B in effect liable for a portion of this loan?

What if A and B contributed cash to LLC as a capital contribution? They would get basis. What if LLC then loaned this cash back to A and B? They should still have basis for the capital contributions.
X, Y and Z formed XYZ, LLC years ago. Each made capital contributions of $100.

XYZ, LLC owns 3 parcels of real estate. Each parcel was acquired years ago for $100. Each parcel is now worth $500.

X will withdraw from XYZ and receives one of the parcels from XYZ.

XYZ is not taxed on the distribution of property to X (§731(b))

X is not taxed on the receipt of property (§731(a))

X has a basis in the property received equal to his $100 basis in his LLC interest (§732)
Same facts except X is in a dispute with Y and Z. The dispute is resolved by the parties entering into a settlement agreement.

- Settlement agreement provides that X will be redeemed. X does not want cash (taxable) nor does he want one of the existing properties. X wants XYZ to acquire and distribute to him Property A (worth $750,000). XYZ has $500,000 in available cash.
Settlement agreement provides:

- LLC will use its cash together with $250,000 cash borrowed from X’s relative to purchase Property A. XYZ will purchase Property A through a SMLLC owned by XYZ.

- Within 60 days of the purchase, X will borrow $250,000 from Bank secured by Property A. X will contribute $250,000 to XYZ and XYZ will distribute Property A to X in liquidation of his interest in XYZ. X agrees to reimburse XYZ for carrying cost of Property A.

- X has no right to possession of Property A prior to distribution.

- If X can’t arrange the $250,000, XYZ can sell Property A, and any profit and balance of funds will be paid to X.

- IRS audits and concludes X is taxed on the $500,000 even though X acquired Property A. XYZ acquired Property A shortly before distribution. Property A was never XYZ’s property for tax purposes – XYZ was X’s agent

- IRS also applied 1.701-2 “anti-abuse” regs to recast the transaction. Also, step transaction doctrine

- Where is the line between a “good” structure and “bad” structure?
A single member LLC ("SMLLC") that does not elect to be a corporation is a “disregarded entity” ("DE").

If an entity is disregarded, its assets and activities are treated as a sole proprietorship, branch or division of the sole owner.
Note that a SMLLC could elect ("check the box") to be taxed as a corporation (and could make an S election). Treas. Reg. §301.7701-3(c).


IRS Notice 2012-52, 2012-35 IRB 317 – SMLLC owned by a U.S. charitable organization is disregarded. Gifts to SMLLC are treated as made to the sole member.

See Berkshire Bank v. Ludlow, Mass, No. 12-1625 (1st Cir. 2013) – SMLLC is “nominee” of owner for purposes of a federal tax lien attaching to SMLLC assets (Section 6321).

Costello v. Com’r, TC Mem. 2016-184 – owner of SMLLC liable for employment taxes of SMLLC.
CCA201351018 – Partnership has two partners, A and B. Partnership becomes a disregarded entity (“DE”) when B withdraws as partner and becomes an employee. See Rev. Rul. 99-6.

- DE should continue to use the former Partnership’s EIN for employment tax purposes.

- Income and losses should be reported by A on Schedule C of Form 1040.

- Consents to extend statute of limitations must be signed by A.

- LP is a limited partnership for state law purposes. LP has not checked the box to be taxed as a corporation.

- Y is a SMLLC that has not checked the box.

- X is deemed to own 100% of LP; thus LP is a DE.
- LLC is a DE. Member is deemed stockholder of S Corp. Assuming Member is a permitted S stockholder, having LLC as intervening entity is not a problem.

- Note: if LLC checked the box, it could make an S election and S Corp could become a QSUB (see below).
- **Ltr. Rul. 200439027 (9/24/04).** Member treated as the (income tax) owner of LLC interests owned by Grantor Trust. Thus LLC treated as SMLLC and a DE.
A partnership is not an eligible S Corp stockholder. LLC is now a tax partnership; thus, S status is gone.

Note: LLC could check the box and make an S election. S Corp could become a QSUB if 100% owned by LLC.
Section 1361(b)(3)(B) – a corporation wholly owned by an S Corporation can, by election, be treated as a DE (Qualified S Subsidiary, or “QSUB”).
Note that a merger between DEs is disregarded for tax purposes. Thus, a QSUB could merge into a SMLLC owned by the S Corp parent without tax consequences.

Actual Retitling of assets from a QSUB to the S Corp and from the S Corp to the QSUB is disregarded for income tax purposes (but watch state and local transfer taxes).
Section 856(i) – a corporation, wholly owned by a REIT, that does not elect to be a “taxable REIT subsidiary” (“TRS”) is a “qualified REIT subsidiary” (“QRS”). A QRS is a DE.

- Note: Unlike a QSUB, no special election is required.
Assume all of the stock of Target Corp is purchased by S Corp for $1 million. Target Corp has a basis in its assets of $200,000. No 338(h)(10) election is made.

Target Corp becomes a QSUB.

- Basis of Target Corp’s assets remains $200,000. Target Corp’s assets treated as owned by S Corp for tax purposes.
- $1 million purchase price for Target stock “disappears” since the stock of Target, as a QSUB, has disappeared.
- The $1 million purchase price will show up in the basis of S Corp’s stockholders, either as a capital contribution or as a loan. If the purchase price is funded from existing cash of S Corp, it is already in stock basis unless debt financed in which case outside basis will increase as taxable income is used to repay principal.

Problem: Down the road, S Corp sells stock of Target for $1 million. There is gain of $800,000. Offsetting loss is deferred if S Corp is not liquidated in same the next year.
Structuring Taxable Acquisition of S Corp Targets.

- Asset Deals. Potential recapture to seller. Buyer gets basis step up in assets. Could be non-tax issues (consents, etc.).

- Stock Deals. Capital gain for seller. Buyer does not get basis step up in assets.

- Stock Deals treated as Asset Deals – 338(h)(10) Election.


**NOTE:** Same result on 338(h)(10) but no need for a corporate buyer of stock.
S CORPORATION PLANNING

- S Corp sells its assets for $1 million. Assets have a basis of $200,000. Stockholders have a basis in the stock of $200,000. Sale is in exchange for a $1 million note payable over 5 years. S Corp liquidates and distributes the note to stockholders.
  - Installment sale is available to the stockholders and report $800,000 gain over 5 years.

- Same facts except consideration is $100,000 cash and $900,000 note:
  - Cash causes gain and stock basis increases to $300,000.
  - Problem when multiple assets are distributed in liquidation of S Corp, the $300,000 stock basis is allocated among the assets based on relative FMV. This $100,000 cash distribution only carries with it $30,000 of basis, thereby triggering phantom gain.

- Fix: Change $100,000 cash to a short-term note from purchaser with say 5% due in January of next taxable year.
S Corporation Planning (Cont’D)

- S Corp has 2 classes of stock: Voting and Nonvoting. Purchaser wants to buy all S Corp stock. Voting stockholders want a premium. Does this cause S election to be blown? No.

- What if same facts except 338(h)(10) election is made causing a “deemed” asset sale? Reg. §1.361-1(L)(2)(v) provides that this will not blow the S election for the year of sale “provided that the varying amounts are determined in arm’s length negotiations with the purchaser.”
  - Make sure there are negotiations on this issue. Will purchaser care?
  - Make sure Purchase Agreement has language that addresses the point.
Treas. Reg. §1.1361-6(b)(1) – if QSUB election terminates, the QSUB is treated as a new corporation.

Section 351 Analysis

Note QSUB cannot make an S election on these facts.

Solution: convert QSUB to LLC before admission of Investor?
What if Investor receives 21% of stock of QSUB?

- Section 1361(b)(3)(C) - Statutory change to mirror tax consequence if QSUB were an LLC.

What if Investor purchases 100% of stock of QSUB?

Acquisition Corp wishes to acquire S Corp in a tax free re-org under Section 368. The sole consideration to be received by S Corp stockholders will be stock in Acquisition Corp.

Acquisition Corp does not want to have S Corp merge directly into Acquisition Corp. Acquisition Corp forms LLC (as a DE) and S Corp merges into LLC with LLC surviving.

Treas. Reg. § 1.368-2(b)(1) treats this as a valid (a)(1)(A) re-org.
- Regulations also approve the merger into a DE owned by a subsidiary corporation in exchange for stock of the parent corporation when the DE survives.

- Section 368(a)(2)(D)
Treas. Reg. 1.368-2(b) provides that this is not a good re-org unless it qualifies under 368(a)(1)(C).
- S Corp has two business Divisions, A and B.
- Stockholder is marketing S Corp and it appears that a Buyer wants to purchase all of S Corp stock (and elect under 338(h)(10)) but Buyer does not want to acquire Division B.
- Stockholder forms New S Corp and contributes all of the stock of S Corp to New S Corp.
- S Corp becomes a QSUB
- S Corp then distributes Division B to New S Corp (disregarded transaction).
- New S Corp can now sell stock of S Corp to Buyer. Note that Buyer will not need 338(h)(10) election because deemed asset acquisition.
- S Corp has $50 million in cash, $30 million of real estate, a widget business worth $20 million, a $25 million casino business which includes a nonassignable casino license.

- S Corp has been an S corporation for more than 10 years. It has $5 million of AAA and $50 million of C corp E & P. S Corp has a low basis in its real estate and widget business assets. Its basis in the casino assets is equal to value.

- The sole stockholder has an outside basis in the S Corp stock of $150 million.

- Stockholder wants to get cash out of corporate solution. He also wants to have the real estate assets separated from the widget business. For several reasons, a tax free spinoff is not available.
If S Corp distributes its cash to the stockholder, once the distribution eats through the AAA, the remaining distribution is taxed as a C corporation dividend – wasted money!

The E&P problem goes away in a complete liquidation. Problem with a “traditional” complete liquidation is the need to assign the casino assets including the nonassignable license.

Step 1: Stockholder forms Holding LLC. Stockholder contributes all of the stock of S Corp to Holding LLC in exchange for 100% of the membership interests in Holding LLC. Note: if Holding LLC is a disregarded entity, it is ignored in determining whether S Corp has permitted stockholder. Further Note: if Holding LLC is disregarded, nothing is accomplished because we still need to liquidate S Corp without assigning the casino license.

Step 2: Holding LLC elects to be taxed as a corporation and it makes an S election. By this, S Corp becomes a QSUB and a disregarded entity for tax purposes. This would constitute an F reorg and S Corp’s E&P would travel upstream to Holding LLC (i.e., it does not evaporate!). At this point, there has been no actual asset ownership change. All assets are still owned by S Corp, although for tax purposes they are all deemed owned by Holding LLC.

Note: See Rev Proc 2009-41, 2009-39 IRB 1, where guidance is provided for late elections under check-the-box regs.
Step 3: S Corp actually distributes to Holding LLC all of its assets except the casino license (and perhaps other casino assets). These actual distributions are ignored for tax purposes because S Corp is a disregarded entity.

Step 4: Holding LLC now reverses the check-the-box election, thus becoming a disregarded entity. This election triggers a deemed liquidation of Holding LLC (an S corporation for tax purposes). Even though assets do not get retitled, all assets of Holding LLC are treated, for income tax purposes, as having been distributed by Holding LLC (an S corp) to the stockholder who in turn contributed them back to Holding LLC, now treated as a single member LLC, disregarded entity for tax purposes. Moreover, the casino license and assets are treated as having been contributed by Holding LLC to S Corp which is converted from disregarded entity (QSUB) to a new S corporation (assuming an S election is made).

Note that the deemed liquidation of Holding LLC as S corporation, triggers gain at the entity level which increases outside basis. Because of the high outside basis prior to liquidation, the result is taxable gain may be offset by a capital loss on the deemed liquidation.

Note: if retained assets (i.e., casino) are more than 20% - could have liquidation/reincorporation. On these facts, it is a close call.

Note: What if S Corp is owned by two stockholders so Holding LLC will not be disregarded after the deemed liquidation? The analysis is similar except that Holding LLC would need to actually distribute the stock of S Corp up to the two stockholders in order to have S Corp make a new S election (a partnership is not a permitted S stockholder).
COMPLETE LIQUIDATIONS USING CHECK-THE-BOX REGS (CONT’D)

STEP 1

SH

Holding LLC

S Corp

- Holding LLC – checks the box
- Holding LLC – S election
- S Corp becomes QSUB
Deemed distribution of assets from S Corp to Holding LLC. Also want actual distribution for state law purposes as well.

Actual (and deemed) distributions are disregarded for tax purposes.
Holding LLC reverses check-the-box election, triggering a deemed liquidation of Holding LLC (then an S corp for tax purposes)

No actual change in ownership need occur (but they can occur if desired (e.g. SH wants the cash; real estate should be in separate entity etc.)

S Corp becomes a regarded corporation and S election is made. Note: casino never retitled.
- S Corp owns all of the operations of a manufacturing business. S Corp has been an S Corporation for more than five years.
- Buyer wants a basis step up in the S Corp assets.
- A, B and C want to retain a 15% equity interest in S Corp.
Pure Stock Purchase. If Buyer purchases 85% of the stock owned by A, B and C with no 338(h)(10) election [need to be at least 80% purchase], A, B and C would have all capital gain. Buyer would not step up asset basis. Transaction would likely cause S Corp’s S election to terminate—not good for A, B and C.

338(h)(10)/336(e). If an election under 338(h)(10) or 336(e) were made, the transaction would be treated as an asset sale. Buyer would get a basis step up in the assets. Gain would probably carry some ordinary income. Problem is A, B and C would be taxed even if they are rolling over equity.
A, B and C form New S Corp and they contribute all of their Old S Corp stock to New S Corp. Old S Corp becomes a QSUB. This is an F reorganization.

Old S Corp converts to a New LLC. This could be done by merger. Disregarded entity converts to a disregarded entity—transaction disregarded.

Buyer purchases 85% of LLC interests from New S Corp. New S Corp retains 15% LLC interest.
A, B and C only taxed on the 85%, not 100%.

Buyer gets basis step up on 85% of the assets. Section 704(c) would apply.

Pass Through treatment for A, B and C is preserved.

Note: What if A, B and C want their rollover equity to be at the parent level of Buyer. Could the 15% interest in New LLC be contributed by New S Corporation to the Buyer entity in exchange for equity in Buyer? If Buyer is a tax partnership, then Section 721 would permit a tax-free rollover. If Buyer is a corporation, New S Corp’s contribution would only work if the “control” test of Section 351 were satisfied.
REV. RUL. 99-5: SITUATION 1

Taxpayer 

SMLLC

100%

$5,000

50%

Buyer

Taxpayer

LLC

50%

50%

Buyer
REV. RUL. 99-5: SITUATION 2

Taxpayer

SMLLC

100%

Buyer

$10,000

Taxpayer

LLC

50%

50%

Buyer
Taxpayer deemed to have sold a 50% undivided interest in assets. Taxable (except 1031).

Buyer deemed to have purchased a 50% undivided interest in assets.

Taxpayer and Buyer are deemed to have formed a new partnership.

704 (c) allocations.

No 721(b) investment company issue because no diversification.
- Buyer and Taxpayer are deemed to have formed a new partnership
- Buyer contributes $10,000
- Taxpayer contributes assets of SMLLC
- Generally, nontaxable under 721 (except could have investment company problem under 721(b)).
**REV. RUL. 99-6: SITUATION 1**

Diagram:

- **A** (50%) to **B** (50%) through LLC (50%)
- **A** (100%) to **SMLLC** (100%)
REV. RUL. 99-6: SITUATION 2

C

50%

D

50%

LLC

E

100%

LLC

E

50%

LLC
B deemed to sell his LLC interest to A
A deemed to purchase B’s share of AB’s assets
AB becomes a disregarded entity
Note: A could use the purchase as 1031 replacement
What if AB redeems B’s interest? Does A get any basis step up? Does B avoid 25% recapture?
C and D deemed to sell CD LLC interests to E
E deemed to purchase former CD LLC assets
CD LLC is now a disregarded entity
Note: E could use purchase as 1031 replacement
AICPA issued a letter to the IRS on October 1, 2013 stating that Rev. Rul. 99-6 should be revoked and that the purchaser in this context should be treated as purchasing a partnership interest.

- This would preclude the purchaser from using the purchase as the replacement leg of a 1031 exchange.

If Rev. Rul. 99-6 is not revoked, the AICPA identifies a number of issues where clarification is necessary.

- To what extent are liabilities of the entity treated as assumed by the purchaser?
- Sections 704(c)(1)(B) and 737 “mixing bowl” provisions should not apply to the deemed distribution of assets.
- Section 751(b) should not apply to the purchaser -- Purchaser should take a substituted basis in Section 751(b) assets increased by gain recognized by seller under 751(a).

See also AICPA comments to IRS dated June 5, 2013 on Rev. Rul. 99-5.
Restaurant Sub LLC is a disregarded entity all of the interests in which are owned by SJ Partnership. SJ Partnership owns real estate that is leased to Restaurant Sub LLC which operates a restaurant.

Restaurant Sub LLC borrows $1 million from Bank. SJ Partnership is not liable on the debt, nor is Sam or Joe.
Restaurant Sub LLC files for bankruptcy. Can Sam and Joe avoid COD if the debt is discharged in bankruptcy? Section 108(a)(1)(A) excludes from COD income if the discharge “occurs in a title 11 case.” The “taxpayer” must be under the jurisdiction of the bankruptcy court. Is Restaurant Sub LLC the “taxpayer”? Treas Reg §1.108-9(a) says the owner of the disregarded entity must be subject to the jurisdiction of the bankruptcy court as the “title 11 debtor.”

Treas Reg §1.108-9(b) provides special rules for partnerships. The bankruptcy exception to COD is applied at the partner level (“look to each partner to whom income is allocable”). Thus for Sam and Joe to benefit from the bankruptcy exception, SJ Partnership and Sam and Joe need to be subject to the jurisdiction of the bankruptcy court. See also Section 108(d)(6).

What if Restaurant Sub LLC does not file for bankruptcy but it is insolvent. Bank is willing to reduce the debt to $400,000. At the time, Restaurant Sub LLC is insolvent by $700,000. Thus, after the debt reduction, it is still insolvent by $100,000. Section 108(a)(1)(B) provides an exception to COD income to the extent the taxpayer is not rendered solvent by the debt discharge.

Treas Reg §1.108-9(a) provides that the insolvency exception applies at the level of the owner of the disregarded entity. Further, in the case of a partnership, the test is at the partner level.
Howard Mylander, T.C. Mem. 2014-191. The taxpayer was a dentist who also engaged in real estate activities.

1980’s taxpayer invested in Hidden Paradise Ranch and invited Koch to invest $400,000 to help finance it. Koch agreed, provided taxpayer guaranteed Koch’s investment. The investment failed and Koch sought payment from taxpayer.

Around the same time, taxpayer met Ledbetter. Ledbetter had invested in a deal with Murray. That venture failed and Ledbetter filed bankruptcy. Murray and Ledbetter settled whereby Ledbetter executed $500,000 note to Murray. Murray conditioned the deal on taxpayer’s guarantying $300,000 of the $500,000 debt. Ledbetter convinced taxpayer to execute this guarantee by promising to pay the Koch debt.

Ledbetter owned a convenience store in Nevada which he led taxpayer to believe was worth at least $400,000 and could be transferred to Koch to satisfy taxpayer’s debt to Koch. Ledbetter also agreed to indemnify taxpayer for any payments made to Murray. The convenience store was worthless and taxpayer ultimately paid Koch.

Ledbetter is the deadbeat here. By 2010, taxpayer paid Murray all but $102,000 under the guaranty with Murray. Murray agreed with taxpayer that the remaining $102,000 need not be paid.
Government’s position was that the guaranty became the primary obligation of the taxpayer and the forgiveness resulted in cancellation of indebtedness income to the taxpayer.

Taxpayer argued that the guaranty was merely a contingent obligation and the forgiveness did not trigger COD income. Hunt, 59 T.C. Mem. 635 (1990); Landreth, 50 T.C. 803 (1968).

Tax Court agrees with taxpayer. Obligation to Murray was secondary. However, the obligation became primary when Ledbetter defaulted and Murray obtained a judgment against taxpayer. Even so, taxpayer does not have COD income because he never enjoyed an increase in net worth from the arrangement. Taxpayer did not realize any untaxed increase in wealth any more than had he remained a secondary obligor.
COD OR GAIN ON SHORT SALE?

- **Simonsen v. Com’r**, 150 T.C. No. 8 (2018) where Taxpayers converted their principal residence to rental property. Property value was less than the mortgage which was nonrecourse.

- Property was subsequently sold per a “short sale.” Taxpayers received a 1099-C (Cancellation of Debt) from the lender and a 1099-S (Proceeds of Real Estate Transaction) from title company.

- Taxpayer reported loss on the “sale” and COD on debt forgiveness. Taxpayer took position COD was excluded from income because of exception for discharge of “qualified principal residence indebtedness.”

- Tax Court concluded that, because debt was nonrecourse, forgiveness was not COD but part of amount realized.

- When property converted from personal use to rental, the adjusted basis for calculating loss is lesser of existing basis or FMV at time of conversion. For calculating gain, adjusted basis applies. Reg. §1.165-9(b).

- In Simonsen, the Section 165 regs resulted in no gain or loss because the amount realized fell in-between the 2 basis numbers. *See* also Reg. §1.1015-1(a)(1) (gifts and donee basis).
**INTERPLAY OF COD AND DISPOSITION OF PASSIVE ACTIVITY**

- **CCA 201415002 (2-11-14)** – A purchases real property for $1 million which is financed with a $1 million recourse mortgage. The property is leased and the losses allocated to A are passive under Section 469. A has no passive income so the passive losses are suspended.

- Several years later, A defaults on the loan and the lender forecloses. The value of the property is $825,000, the debt is $900,000 and the basis is $800,000. As part of the foreclosure, lender cancels the $75,000.

- A has $75,000 of COD. Because A is insolvent, he can exclude from income the COD (to the extent he is not rendered solvent). A has gain on the foreclosure of $25,000.

- Does the foreclosure trigger a complete disposition of the passive activity so that A can deduct his suspended losses? Yes.

- The fact that the COD is excluded from A’s income because he is insolvent does not cause a reduction in the suspended losses eligible for deduction.
EXCHANGE-100% LLC INTERESTS OF DISREGARDED ENTITY AS REPLACEMENT PROPERTY

Diagram:
- Davis
- QI
- Relinquished Property
- Buyer
- Proceeds

QI (Qualified Intermediary) acts as a conduit for the exchange of property, handling the funds (proceeds) between the relinquished property owned by Davis and the replacement property purchased by the Buyer.
• Swap SMLLC owns like kind property. Davis acquires 100% of the membership interests. This is a good exchange.
EXCHANGE – 100% LLC INTERESTS OF PARTNERSHIP AS REPLACEMENT PROPERTY (CONT’D)

Davis

Relinquished Property

QI

Proceeds

Buyer
- Swap LLC is a tax partnership. Davis acquires 100% of the membership interests as replacement property.
• Davis treated as acquiring the assets of Swap: A good exchange.
BAD EXCHANGE – PURCHASE OF PARTNERSHIP INTEREST

Davis → Relinquished Property → Buyer

QI
• Davis only acquires the membership interests from Tom and Dick.
• Swap LLC remains a tax partnership. Davis is treated as having acquired membership interests: Bad Exchange!
• Davis is treated as having relinquished the assets of LLC.
Tom, Dick and Harry are treated as having acquired the assets of Swap LLC and then to have contributed the assets to a new tax partnership.
• Davis is treated as having sold a 50% undivided interest in the assets of SMLLC. This is a good first leg of a like kind exchange.
This is treated as a sale of QSUB assets.
EXCHANGE - PARTNERSHIP INTEREST AS REPLACEMENT PROPERTY

QI

Davis

Relinquished Property

Buyer
EXCHANGE – PARTNERSHIP INTEREST AS REPLACEMENT PROPERTY (CONT’D)

Davis

Edward

Real Estate LLC

60%

40%
• The replacement property is Edward’s membership interest in Real Estate LLC.
• Edward is treated as having sold a membership interest but Davis is treated as having purchased assets: A good exchange!
EXCHANGE-PARTNERSHIP INTERESTS AS RELINQUISHED PROPERTY

Davis

Edward

LLCI

50%  50%
EXCHANGE-PARTNERSHIP INTERESTS AS RELINQUISHED PROPERTY

- **Davis**
- **Edward**
- **QI**
- **LLCII (continuation)**
- **Relinquished Property**: 100% LLCI
- **LLCI (disregarded)**

*Buyer*
HANDLING PARTNER EXITS IN 1031 EXCHANGE

A | 1/3
B | 1/3
C | 1/3

Real Estate LLC

Cash

1/3 Cash

Buyer

2/3 Cash

QI
A, B, and C are equal members in Real Estate LLC. Buyer is proposing to purchase Property owned by Real Estate LLC. A and B would like to do an exchange

What if Buyer pays 2/3 of the purchase price to a QI and 1/3 to Real Estate LLC. Real Estate LLC distributes the cash to C in liquidation of his interest.

What if Real Estate LLC dissolves before the sale so that A, B and C are tenants in common before the sale? What if Real Estate LLC distributes a 1/3 undivided interest to C in liquidation of his interest prior to the sale?

What if prior to the sale, A and B purchase C’s interest? Alternatively, what if A and B arrange for Real Estate LLC to borrow funds to liquidate C’s interest before or after the closing?
If Real Estate LLC receives cash, this will be taxable “boot.” This would not be a problem if all of the boot could be specially allocated to C. Even if the members amend the operating agreement to provide for such a special allocation, this allocation may not be viewed as having “substantial economic effect.”

One frequently used technique is for an installment note (secured by a standby letter of credit) to be used in lieu of cash. The installment note could provide for 95% of principal to be paid 3 days after closing and 5% to be paid the following January. The note would be received by Real Estate LLC and distributed to C. The receipt of the note does not trigger boot and the distribution of the note to C is not an acceleration event. Also, A and B have a smaller reinvestment requirement than would be the case if A and B bought out C using separate funds.

A dissolution of Real Estate LLC or a spin off of an undivided interest to C could create “holding” issues and/or the arrangement could still be viewed as a de facto partnership for income tax purposes.

If A and B cause C to be bought out using separate funds, A and B would be stuck with a larger reinvestment requirement.

- EAT – “Exchange Accommodation Titleholder” will be treated as the beneficial owner for tax purposes.
- “Qualified Exchange Accommodation Arrangement”
- Time limits – 45 days and 180 days. Thus safe harbor only permits parking for 180 days.

Taxpayers may need to park property for more than 180 days. In this case, taxpayers attempt to structure the terms so the exchange accommodation party has benefits and burdens of ownership for tax purposes. Estate of Bartell, 147 T.C. 140 (2016) is a taxpayer victory in this context. On August 14, 2017, the government issued an Action On Decision (AOD 2017-06, 2017-33 IRB 194) in which it indicated that it does not acquiesce in Bartell.

Taxpayer contracted to purchase Replacement Property in 1999 at a time when Taxpayer did not have any Relinquished Property. The Replacement Property was to be a drug store to be constructed.
Taxpayer arranged to have an exchange facilitator ("EF") acquire the Replacement Property in August of 2000 with bank financing guaranteed by Taxpayer.

Taxpayer managed construction of the improvements and leased the finished property from EF.

On December 31, 2001, Taxpayer sold its Relinquished Property and purchased the Replacement Property from EF.

- Tax Court held that EF was respected as the tax owner of the Replacement Property during the period of August 2000 until December 31, 2001. As a result, Taxpayer had a good 1031 exchange.
Assume that Taxpayer owns real estate having a value of $1 million and a basis of $300,000. The property is subject to a nonrecourse debt of $1.1 million. Taxpayer and Bank agree that Taxpayer will transfer the property to Bank. Can Taxpayer structure this as a like-kind exchange to defer the $800,000 gain?

Yes – see Ltr. Rul. 201302009 (10-10-12).

Taxpayer needs to assign its contract with Bank to a QI just as in any deferred exchange.

Taxpayer will need to fund the replacement property with new money and will need to arrange $1.1 million of new debt on the replacement property.

If the debt were recourse debt, an exchange would also work except that the excess of $1.1 million over $1 million will be COD income which cannot be avoided by Section 1031. The $700,000 of gain can be deferred using an exchange.
Discounting a Disregarded Entity?


Discounting value of LP or LLC interest is premised on respecting the "entity wrapper." What happens when interests in a single member LLC are transferred? Can the values be discounted because of lack of marketability and minority interest?

- In Pierre, taxpayer formed a single member LLC (Pierre LLC) and contributed $4 million in cash and marketable securities to it on September 15, 2000. On September 27, 2000, taxpayer transferred 100% of her membership interests to 2 trusts, one for the benefit of her son and one for the benefit of her grandson.

- More specifically, taxpayer made 2 gifts — 9.5% interest gifted to each trust; and taxpayer made 2 sales — 40.5% interest to each trust in exchange for notes.

- Note: if the trusts were grantor trusts, taxpayer still treated as owner for income tax payment — so Pierre LLC would remain a disregarded entity after the transfers.
DISCOUNTING A DISREGARDED ENTITY (CONT’D)

- IRS argues disregarded entity must be disregarded for gift and estate tax valuation purposes – entity “wrapper” must be disregarded – taxpayer deemed to have made gifts of undivided interests in assets.

- Taxpayer argues, and Tax Court agreed, state law attributes control. Willing buyer/willing seller. The “fiction” under the check-the-box regs of a disregarded entity does not apply to ignore attributes of the LLC interest being transferred. Thus, another example of disregarded entities not being disregarded. See also Treas. Reg. §1.752-2(k) (disregarded entity not disregarded in testing recourse debt).

- What about Rev. Rul. 99-5, 1999-1 C.B. 434? Sale of an interest in a single member LLC treated as sale of undivided interest in each asset!

- In Suzanne J. Pierre, T.C. Mem 2010-106 (“Pierre II”), the Tax Court considered whether the “step transaction” doctrine should apply to cause the gift and the sale of two 50% interests to be aggregated. While the Tax Court agreed with the government, the change in the applicable discounts was less than 1% (from 36.55% to 35.6%).
Smith formed LLC as a disregarded entity. LLC has two Classes of Interests: Class A and Class B. Smith subsequently transfers, by “sale” or gift, the Class B Interests to Grantor Trust. LLC remains a disregarded entity.

The LLC operating agreement provides that losses are allocated solely to the Class A and certain tiers of income are allocated solely to the Class B. Purpose is to boost basis in Class B interests.

In recent IRS Advice (AM 2012-001 released 2/17/12), the Service advised that interests in a disregarded entity cannot be split into separate classes and taxpayers may not make disproportionate allocations between classes. A disregarded entity does not have “membership interests” for tax purposes.

Ringgold Telephone Co., TCM 2010-103 (5-10-10). The taxpayer was a C corporation that elected S status effective Jan 1, 2000. March, 2000, the taxpayer hired an investment banking firm to market its 25% interest in CRC. In November, 2000, Bell South purchased the 25% interest for $5.2 million.
Question presented is the amount of BIG under Section 1374. Taxpayer’s experts valued the interest at $2.98 million as of Jan 1, 2000 (applying discounts for lack of marketability and minority interests). IRS experts argued best evidence of value was “reasonably contemporaneous arms’-length sale.”

Tax Court determined $3.7 million value as of January 1, 2000. Thus $1.5 million of amount realized escaped double tax.

What if CHAT had sold all of its assets, with CRC receiving $20.8 million of cash (Ringgold receiving $5.2 million). Would the discount at $3.7 million still apply? Yes. Treas. Reg. §1.1374-4(i)(2) & (i)(8), Ex. 3.

But also see Treas Reg. §1.1374-4(i) for post election contributions to and distributions from partnerships. Also, anti-abuse rule.

Compare Pope & Talbot, Inc. v. Com’r, 162 F.2d 1236 (9th Cir 1999) (no discounts permitted under Section 311 for distributions of limited partnership interests to stockholders). See also TAM 200443032 (7-13-04).

Note: Section 1374 is now a 5-year trap instead of a 10-year trap.
Whiteacre, Inc. is a C corporation all of the stock of which is owned by Bob White. Whiteacre, Inc. owns a large ranch in Texas (of course, all ranches in Texas are large!) The ranch has substantially appreciated from its cost of $2 million in 1965 to a present value of $40 million. The ranch generates income from oil and gas working interest as well as from livestock. The ranch will appreciate in the future.

Bob is 68 years old and has three children. Bob would like to shift value out of his estate. He is planning to make an S election for Whiteacre but this will not help with future appreciation. Bob could make gifts of minority interests in Whiteacre, Inc. to his children but he needs to cap the appreciation on what he retains.
Bob’s tax advisor developed the following plan: Whiteacre will contribute the ranch to a newly formed limited partnership (“LP”). The children will also contribute to the LP. Whiteacre will receive a “preferred interest” in the LP that will have a cumulative preference on cash flow of $2 million per year and a 5% residual share thereafter. The preferred interest will have a right to the first $40 million on a sale or refinancing and a 5% residual. If the ranch appreciates in the future, substantially all of the appreciation will be deflected to the younger generation. Will this work?

- 5 year BIG under 1374 will apply on S election.
- If Whiteacre is liquidated after BIG period, gain will be triggered.
- If liquidate Whiteacre after BIG period and after Bob’s death then no gain to Bob’s estate (but if gifts of stock had been made, could still be a problem for those stockholders).

Partnerships between a corporation and its stockholders have been respected. But what is the business purpose?

- Watch “Sham” argument
- Watch §701 anti abuse regs. Government has indicated informally that Section 7701(o) (codification of economic substance) should not be a concern in freeze transactions (see Tax Notes, 6-11-13)

Valuation must be accurate to avoid constructive dividend/gift.

- §704(c) will apply
- §482 could apply
- Chapter 14 could apply

See Ltr. Rul. 201722008 (6-2-17) – Recapitalization of freeze LLC with S corporation exchanging preferred interests for common interests does not trigger 1374 BIG tax.
Smith v. Com’r, T.C. Mem. 2017-218

Based upon advice from tax counsel, Taxpayers formed an S corporation in August of 2009. At the same time, Taxpayers formed a limited partnership 98% owned by the S corporation and 2% owned by the Taxpayers as general partners.

Taxpayers contributed cash and marketable securities to the S corporation which in turn contributed these same assets to the limited partnership.

When the plan was formulated, evidence showed that the Taxpayers intended to liquidate the S corporation by the end of 2009.

The S corporation was liquidated in December 2009 and the limited partnership interests were distributed to the Taxpayers. Tax counsel valued the limited partnership interests with a 40% discount.

Taxpayers took an ordinary loss on the liquidation.

Tax Court concludes no loss and imposed penalties. Transaction had no economic substance.
- Estate of Church, 268 F.3d 1063 (5th Cir. 2001).

- October 22, 1993. Mrs. Church and her two children contributed undivided interests in a ranch to an FLP. Mrs. Church also contributed $1 million in liquid assets. Mrs. Church received LP interest; children controlled corporate GP.

- October 24, 1993. Mrs. Church dies. She had been diagnosed with cancer but died of heart attack. Documents had been executed but LP certificate had not been filed with state of Texas. Corporate GP was not formed until several months later. $1 million brokerage account was not retitled to the LP for months.

- Estate took 58% discount on LP interest. Government did not produce a valuation expert - - thought the facts were compelling that taxpayer could not prevail.

- Taxpayer wins! Partnership “wrapper” should not be disregarded. Sloppy documentation evidence of no tax avoidance intent or devious motive!
Rayford L. Keller v. United States, No.6:02-CV-00062 (S.D. Tex 2009), Aff’d No. 10-41311 (5th Cir 2012).

Taxpayer intended to form an investment partnership consisting of an existing Vanguard bond portfolio. The two LPs were trusts (included in taxpayer’s estate) and a corporation was to be the GP.

Taxpayer was to initially own all of the membership interests in the GP but she intended to sell these interests to family members.

March 2000 – Taxpayer diagnosed with cancer but death not imminent.

May 2000 – Documents were finalized and advisers visited taxpayer in hospital and had documents signed although there were blanks for the values of the capital contributions. Taxpayer also signed documents to form the GP. Advisers filed for EINs and called Vanguard.

May 11, 2000 – Certificates filed with Texas

May 15, 2000 – Taxpayer dies. At the time no assets had been retitled in the name of the partnership and “Schedule A – Contributions” remained blank.
Taxpayer’s advisers initially did not feel the entities had been fully formed at date of death. Estate pays tax based on no discounts.

May 17, 2001 [One Year after Death!] – Taxpayer’s adviser attends seminar and learns of Church case. Advisers then moved forward to complete the entities; transfer assets.

On November 15, 2001 – Claim for refund filed.

Based on reasoning in Church, court in Keller sides with Taxpayer. Partnership was validly formed.

Better late than never!